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'TIS A GIFT TO BE SIMPLE: THE NEED FOR A NEW DEFINITION OF "FUTURE INTEREST" FOR GIFT TAX PURPOSES*

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The most troublesome and most frequently litigated issue in gift tax law is undoubtedly the availability of the "annual exclusion" authorized by section 2503(b).[1] Under current law, a donor, in calculating his "taxable gifts" for the calendar year,[2] may exclude from consideration the first $10,000 of the gifts he makes to each donee during the year. For example, if *D* gives a total of $12,000 to *A* in 1986 and a total of $15,000 to *B* in 1986, *D*'s taxable gifts for 1986 will amount to only $7,000, for *D* may exclude the first $10,000 of his gifts to *A* and the first $10,000 of his gifts to *B*.[3] Although Congress has from time to time changed the dollar amount of the an-

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1. Hereinafter, all section numbers will refer to the Internal Revenue Code of 1986 as amended, unless otherwise indicated.

2. Gift tax returns are generally prepared and filed on a calendar-year basis. §§ 6019, 6075(b). (Prior to the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520 (1976), they were prepared and filed on a quarterly basis.) A donor's gift tax liability for a calendar year is determined by the value of the "taxable gifts" he has made. The term "taxable gifts" for a given calendar year is defined in § 2503 as the gross amount of the donor's gifts for that year, minus the following five amounts, if applicable: (1) the charitable deduction of § 2522; (2) the marital deduction of § 2523; (3) the exclusion for certain educational or medical payments pursuant to § 2503(e); (4) the exclusion for certain waivers described in § 2503(f); and (5) the annual exclusion of § 2503(b).

3. If, instead, *D* gives $8,000 to *A* in 1986, and $19,000 to *B* in 1986, *D*'s taxable gifts will amount to $9,000. The $2,000 of "unused" exclusion with respect to *A*'s gift may not be applied against *B*'s gift.

nual exclusion,[4] the rules relating to its applicability have remained constant for the most part;[5] and of these rules, the most difficult has always been that relating to future interests.

Section 2503(b) provides that the annual exclusion is available only for gifts "other than gifts of future interests in property;"[6] and it has been held that the term "future interest" as used in section 2503(b) is a distinct term of federal tax art, independent of any state law definitions.[7] Courts in recent years have reached decisions in

4. The annual exclusion made its first appearance in 1932; the amount of the exclusion was $5,000 and remained so through 1938. Revenue Act of 1932, Pub. L. No. 72-154, § 504(b), 47 Stat. 169, 247 (1932). From 1938 through 1942, the amount was $4,000. Revenue Act of 1938, Pub. L. No. 75-554, § 505, 52 Stat. 447, 565 (1938). From 1943 through 1981, the amount was $3,000. Revenue Act of 1942, Pub. L. No. 77-753, § 454, 56 Stat. 798, 953 (1942). For gifts made after 1981, the amount is $10,000. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441, 95 Stat. 172, 319 (1981).

5. In 1937, the Third and Seventh Circuits held that in the case of a gift in trust, the trust itself, rather than the beneficiaries of the trust, was considered the donee for purposes of determining the number of annual exclusions to which the donor was entitled. Commissioner v. Krebs, 90 F.2d 880 (3d Cir. 1937); Commissioner v. Wells, 88 F.2d 339 (7th Cir. 1937). Thus, under these holdings, a donor could, by establishing multiple trusts for the same beneficiary, increase the number of exclusions to which he was entitled. In order to prevent such circumvention of the gift tax, Congress amended the Internal Revenue Code in 1938 to provide that the annual exclusion would be disallowed altogether in the case of gifts in trust. Revenue Act of 1938, Pub. L. No. 75-554, § 505(a), 52 Stat. 447, 565 (1938); *see* S. REP. No. 1567, 75th Cong. 3d Sess. 41 (1938), *reprinted in* 1939-1 C.B. (Part 2) 779, 809. In 1941, however, the United States Supreme Court held that a gift in trust was to be regarded for annual exclusion purposes as a gift to each beneficiary rather than as a gift to the trust *qua* trust. Helvering v. Hutchings, 312 U.S. 393 (1941). Accordingly, Congress restored the annual exclusion for gifts in trust made after 1942. Revenue Act of 1942, Pub. L. No. 77-753 § 454, 56 Stat. 798, 953 (1942); *see* S. REP. No. 1631, 77th Cong., 2d Sess. 243 (1942), *reprinted in* 1942-2 C.B. 504, 682.

6. Since the gift of a "future interest" will not qualify for the exclusion, practitioners use the phrase "present interest" to identify those interests a gift of which *will* qualify for the exclusion. But the phrase "present interest" does not appear in the Code. Strictly speaking, one should, when referring to a qualifying property interest, use a periphrasis such as "something other than a future interest," *see, e.g.*, Commissioner v. Disston, 325 U.S. 442, 449 (1945), rather than the phrase "present interest." The shorter phrase has, however, been so uniformly adopted not only by practitioners but also by the Internal Revenue Service, *see* the examples in Treas. Reg. § 25.2503-3(c) (1983), that "present interest" will hereinafter be used to identify those interests that are not "future interests" within the meaning of § 2503(b).

7. Pelzer v. United States, 312 U.S. 399 (1941).

> [T]he revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. [Citation omitted.]
>
> We find no such implication in the exclusion of gifts of "future interests" from the benefits given by § [2503(b)]. In the absence of any

the future interests area that reveal a disturbing inclination to disregard precedent and to draw distinctions that have no substantial foundation. Moreover, practitioners' concern about the meaning of the term "future interest" has intensified during the last decade or so as the IRS's response to *Crummey v. Commissioner*[8] and its progeny[9] have led to continual disputes[10] concerning the eligibility of certain gifts to minors[11] for the annual exclusion. The needless complexity of these resulting cases and rulings argue strongly for a reappraisal of the definition of "future interest" as a gift tax term.

The purpose of this article is therefore twofold: first, to examine how the definitions of "future interest" and "present interest" have evolved over the years,[12] an examination that will illustrate the in-

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> statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute.

Id. at 402-403. Presumably, the term "present interest" for § 2503(b) purposes is likewise a term of federal tax art. *See supra* note 6.

8. 397 F.2d 82 (9th Cir. 1968).

9. *See, e.g.*, Jacobson v. United States, 78-2 U.S.T.C. 13,256 (D. Neb. 1978); Estate of Kolker v. Commissioner, 80 T.C. 1082 (1983); Naumoff v. Commissioner, 46 T.C.M. (CCH) 852 (1983); Quatman v. Commissioner, 54 T.C. 339 (1970); Rev. Rul 81-7, 1981-1 C.B. 474; Rev., Rul. 73-405, 1973-2 C.B. 321.

10. The frequency of these disputes engendered a flood of articles dealing with so-called *Crummey* powers and *Crummey* trusts. *See, e.g.*, Adam & Bieber, *Making "5 and 5" Equal 20: Crummey Powers After ERTA*, 122 TRUSTS & ESTATES 22 (Sept., 1983); Dye, *Several Routes Exist to Avoid IRS' Income Tax Roadblock to Use the Crummey Trust Provisions*, 10 EST. PLAN. 220 (1983); Natboney, *The Crummey Trust and "Five and Five" Powers After ERTA*, 60 TAXES 497 (1982); Peschel, *Major Recent Tax Developments in Estate Planning: . . . Refining the Crummey Power*, 33 U. SO. CAL. TAX INST. 1401 (1981); Szarwark, *Drafting Crummey Powers: The Current Rulings Scene*, 5 NOTRE DAME EST. PLAN. INST. 483 (1980).

11. Although the *Crummey* case itself dealt with gifts to minors, the issue presented was broader: namely, whether a gift to *any* donee is a present interest if, as a condition of receiving the gift property, the donee must formally make demand for the property. The *Crummey* issue is discussed in more detail *infra* at text accompanying notes 298-300.

12. Section 2503(c), enacted in 1954, allows an annual exclusion for certain gifts to minors: gifts that would otherwise be regarded as future interests. More particularly, if a donor transfers property on the following conditions—the property and the income therefrom may be expended by or for the donee before his attaining the age of twenty-one and will, to the extent not so expended, pass to the donee upon his attaining the age of twenty-one (or be payable, in the event the donee dies before age twenty-one, to the donee's estate or as he may appoint pursuant to a general power of appointment)—then the gift is considered a present interest by reason of § 2503(c). Were it not for the special rule of § 2503(c), such a gift would not qualify for the annual exclusion. *See* Schumacher v. Commissioner, 8 T.C. 453 (1947). But § 2503(c) should not be regarded as an exception to the *definition* of future interest; rather, it is a special, narrow rule designed to encourage—or, at least, not discourage—gifts to minors, since many donors to minors prefer to subject their gifts to restrictions designed to assure prudent

consistency and even uselessness of much of the case law; and second, to propose new definitions that are both simpler and more in keeping with Congress's original purpose in limiting the annual exclusion to gifts of present interests.

I. BACKGROUND

Why did Congress except future interests from the enjoyment of the annual exclusion? The official explanation in the committee reports relates the exception to the peculiarities of the recognized procedure for determining the existence and amount of gifts subject to tax. In fact, however, the exception is better explained in terms relating to the very purpose of the gift tax itself.

To understand Congress's official explanation, one must know that in determining whether an individual has made a gift for gift tax purposes and, if so, what the amount of that gift is, we do not examine what the donee has received but rather what the donor has given up.[13] For example, suppose *D* transfers $100,000 in trust, where the trustee has the unlimited discretion to distribute income or principal in any amounts and at any time to *A*, *B*, or *C*. Although we do not yet know how much any donee will ultimately receive from the trust, it is plain that *D* has made a gift for gift tax purposes of the entire $100,000[14] because he has so parted with dominion and control over the entire amount as to leave in him no power to change its disposition.[15] On the other hand, the determination whether a donor is entitled to claim one or more annual exclusions with respect to a gift depends not on what the donor conveys but rather on what the donee or donees receive.[16] It is necessary to determine the number of donees because the exclusion is a per-donee exclusion; and it is necessary to determine the value of what each

management. *See* Pettus v. Commissioner, 54 T.C. 112, 119-20 (1970). Because § 2503(c) is in substance a separate rule rather than an exception to the definition of future interest, it will not be further discussed in this article except tangentially.

13. "The gift tax is an excise tax imposed, not upon the receipt of property by various donees, but upon the donor's act of making a transfer; and it is measured by the value of the property passing from the donor." Bartman v. Commissioner, 10 T.C. 1073, 1078 (1948). *See* Guggenheim v. Rasquin, 312 U.S. 254 (1941), where a taxpayer made a gift of single-premium life insurance policies immediately after purchasing them. Though the policies cost the donor about $800,000, they had a cash surrender value at the time of the gift of only about $700,000. Although the donees thus received property having a realizable value of only $700,000, the Court agreed with the IRS that the value of the donor's gift for gift tax purposes was the $800,000 figure: the value of what the donor gave up.

14. *See, e.g.*, Robinette v. Helvering, 318 U.S. 184 (1943).

15. Treas. Reg. § 25.2511-2(b) (1983).

16. Wisotzkey v. Commissioner, 144 F.2d 632 (3d Cir. 1944); Priv. Ltr. Rul. 7946007 (July 26, 1979).

donee receives because the exclusion is limited to the lesser of $10,000 or the value of what the donee receives.[17] These facts help to explain why Congress chose to restrict the annual exclusion to gifts of present interests. "[T]he denial of the [exclusion] in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances [of gifts of future interests], of determining the number of eventual donees and the values of their respective gifts."[18]

But this cannot be the whole explanation. As we shall see, there have been many cases in which a donor was denied an annual exclusion on the ground that the donee received a future interest, even though the identity of the donee and the value of what he received were readily ascertainable.[19] For a fuller explanation, we must, as indicated above, consider the purpose of the gift tax itself.

The principal function of the federal gift tax is to prevent or compensate for avoidance of the federal estate tax. The gift tax serves as a back-up for the estate tax by taxing, during a property owner's life, inter vivos transfers of property that, but for the transfer, would have been subject to the estate tax at the donor's death.[20] In theory, every gift, however inconsequential, reduces the potential gross estate[21] of the donor and may therefore be regarded as a device for avoiding federal estate taxes. But it would be burdensome to the point of ludicrousness to require a donor to file a gift tax return reporting every minor, routine gift. The annual exclusion was devised, therefore, "to obviate the necessity of keeping an account of and reporting[22] numerous small gifts, and [yet] to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts

17. *See, e.g.*, Rev. Rul. 80-261, 1980-2 C.B. 279.

18. H.R. REP. No. 708, 72nd Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478.

19. C. LOWNDES, R. KRAMER, & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 33.5, at 810 (3d ed. 1974) [hereinafter C. LOWNDES]; *see, e.g.*, Hessenbruch v. Commissioner, 178 F.2d 785 (3d Cir. 1950); Commissioner v. Glos, 123 F.2d 548 (7th Cir. 1941).

20. *See* Sanford's Estate v. Commissioner, 308 U.S. 39, 44, *reh. denied*, 308 U.S. 637 (1939); Merrill v. Fahs, 324 U.S. 308, *reh. denied*, 324 U.S. 888 (1945). Hence, the decision in Guggenheim v. Rasquin, 312 U.S. 254 (1941), discussed *supra* at note 13, can be defended on the additional ground that to charge the donor with having made a gift of only $700,000 when he had in fact reduced his wealth by $800,000 would be to allow $100,000 to escape federal transfer taxation altogether.

21. A decedent's gross estate is the value of all property that is subject to federal estate tax by reason of his death. The estate tax is imposed on the decedent's "taxable estate," which is his gross estate less certain deductions.

22. If all the gifts that a donor makes during a calendar year are completely offset by the annual exclusion, the donor is not required to file a federal gift tax return for the year. § 6019. [Author.]

and occasional gifts of relatively small amounts."[23] But although this passage explains why Congress enacted an annual exclusion, it seems not to explain why gifts of future interests are denied this exclusion. The explanation is implicit in the passage, however. Minor, routine gifts tend to be gifts of present interests. One seldom makes a gift of a future interest without the advice and intervention of an attorney or other professional. If a gift is in the form of a future interest, it is likely to have been made as much from tax-reduction motives as from a simple desire to make the kind of gift that Congress sought to exempt through section 2503(b). Accordingly, Congress chose, rather than requiring an investigation into the motives prompting each gift of a future interest, to disqualify such gifts altogether for the annual exclusion.

At this point, the reader may wonder why, since the dollar amount of the annual exclusion is relatively small, there should be so much litigation of the question of entitlement to the exclusion. The reasons are twofold. First, a donor may easily multiply the number of exclusions to which he is entitled. For example, a donor with four children and six grandchildren can, by making a $10,000 gift to each, avail himself of annual exclusions totaling $100,000; that is, he can reduce his potential estate by $100,000 without having to pay any transfer tax.[24] Second, it is common for individuals to embark upon a program of annual gift-giving by establishing a trust for the benefit of certain donees and then making annual contributions to the trust. If the IRS determines that the beneficiaries of the trust have received only future interests in the donor's contributions, then the donor's intentions will be frustrated not only for the current year but for each future year as well; so it may be desirable for the donor to challenge in court the IRS's disallowance of the exclusion even though the effects of that disallowance for the current year may be relatively small.

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23. H.R. REP. No. 708, 72nd Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478.

24. And if the donor's spouse consents to having one-half of the gift attributed to her, the donor can reduce his potential estate by 200,000 without having to pay any transfer tax. Section 2513 permits a married donor to double the number of exclusions available to him with respect to donees other than his spouse. If *D* makes a $20,000 gift to *X*, and *D*'s wife consents to "split" the gift with *D* pursuant to § 2513, then one-half of the gift will be deemed to have been made by *D* and one-half by *D*'s wife. That is, each spouse will be treated as having made a $10,000 gift to *X*, and each spouse will accordingly be entitled to a $10,000 annual exclusion with respect to his $10,000 gift. Of course, if *D*'s wife consents to split *D*'s gift to *X*, she will be unable to claim the annual exclusion for any gifts of her own property that she might make to *X* during the year. *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION ¶ 10.03 (5th ed. 1983) [hereinafter R. STEPHENS].

It has been established that the donor has the burden of proving that the transferred property interest was not a future interest.[25] But exactly what is a future interest for gift tax purposes? The Internal Revenue Code contains no definition at all. The definition in the committee reports accompanying the original enactment of the annual exclusion—"any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date"[26]—amounts to a mere dictionary definition and consequently offers little guidance; and the IRS regulation merely repeats almost verbatim the language of the committee reports.[27] The earliest important judicial definition was propounded in the oft-cited case of *Fondren v. Commissioner*:[28]

> [I]t is not enough to bring the [annual] exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess or enjoy the property. These terms are not words of art, like "fee" in the law of seizin [citation omitted], but connote the right to substantial present economic benefit. The question is of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest. . . .[29]

Examination reveals that the cases dealing with the future interests exception can be suitably divided into three groups: (1) cases where the donee's right to the transferred property is unconditional; (2) cases where the donee's right is subject to a condition beyond his control; and (3) cases where the donee's right is subject to a condition within his control. The cases within each group, though they may differ considerably from each other as to facts, nonetheless present comparable legal issues. The following critique of the case law is therefore organized in accordance with this tripartite classification.

25. Commissioner v. Disston, 325 U.S. 442, 449 (1945); *see also* Herrmann's Estate v. Commissioner, 235 F.2d 440, 444 (5th Cir. 1956) (citing *Disston*); Kniep v. Commissioner, 172 F.2d 755, 758 (8th Cir. 1949) (same); Commissioner v. Sharp, 153 F.2d 163, 164 (9th Cir. 1946) (same).

26. H.R. REP. No. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478; S. REP. No. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 526.

27. Treas. Reg. § 25.2503-3(a) (1983).

28. 324 U.S. 18 (1945).

29. *Id.* at 20-21.

II. Cases Involving Unconditional Interests

A. Eligibility of Income Interests for the Exclusion

It was established fairly early in the annual exclusion's existence that an income interest, such as a life estate or term of years under a trust, can qualify for the annual exclusion even though the gift of the underlying property does not qualify.[30] As we shall see, serious anomalies result from this rule,[31] and courts have been able to defend the rule only by lamely pointing out that as a matter of "ordinary usage"[32] among property lawyers an immediate life estate or term of years under a trust is characterized as a present interest. But the rule is now so firmly established that future challenge in the courts is unlikely.[33]

In order for an income interest to be a present interest, the donee must receive an unrestricted right to the immediate use, possession, or enjoyment of a certain share of the trust income.[34] If the trustee is given the option of applying income for the income beneficiary's benefit instead of distributing it to the beneficiary directly, the beneficiary will still be regarded as having received a present interest—note the word "enjoyment" in the previous sentence—as long as such application or distribution of income must begin immediately.[35] But if no distribution (direct or indirect) is required until

30. Fisher v. Commissioner, 132 F.2d 383 (9th Cir. 1942); Commissioner v. Lowden, 131 F.2d 127 (7th Cir. 1942) (1942); Commissioner v. Brandegee, 123 F.2d 58 (1st Cir. 1941); Tidemann v. Commissioner, 1 T.C. 968 (1943), *acq.*, 1943 C.B. 23; *see also* Commissioner v. Disston, 325 U.S. 442 (1945); Fondren v. Commissioner, 324 U.S. 18 (1945).

31. *See infra* notes 310-14 and accompanying text.

32. Commissioner v. Brandegee, 123 F.2d 58, 62 (1st Cir. 1941).

33. The IRS has conceded the point: "An unrestricted right to the immediate use, possession, or enjoyment of . . . the income from property is a present interest in property." Treas. Reg. § 25.2503-3(b) (1983).

34. Herrmann's Estate v. Commissioner, 235 F.2d 440 (5th Cir. 1956); *accord* Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); LaFortune v. Commissioner, 263 F.2d 186 (10th Cir. 1958).

35. Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); Sharp v. Commissoner, 3 T.C. 1062 (1944), *aff'd*, 153 F.2d 163 (9th Cir. 1946); Priv. Ltr. Rul. 8327060 (Apr. 7, 1983); *see* Snyder v. United States, 134 F. Supp. 319 (W.D.N.C. 1955). The crucial factor in this kind of a case is whether the donor *intended* to give the donee the immediate unrestricted right to enjoy the income. In Messing v. Commissioner, 48 T.C. 502 (1967), for example, a donor made gifts consisting of checks and bonds in the names of "*A* in trust for *B*." (*A* was the donor's child; *B* was *A*'s minor child.) The donor deposited these checks and bonds in a bank account likewise designated "*A* in trust for *B*." (Similar accounts for the donor's other grandchildren were established.) It was conceded that the donor intended *B* and not *A* to be the donee, but did *B* receive a present interest. "Petitioner testifies that he intended that his grandchildren have the immediate benefit of the gifts; that the funds be used for their support and maintenance and exclusively for their benefit. . . . We find his testimony wholly credible." *Id.* at 513.

the happening of some future event, the interest is a future interest.[36] Thus, where trust income is to be applied first to pay off a loan and the donee is not entitled to income payments until that debt is cleared, the donee's interest is a future interest.[37] Similarly, where a donor, having made a gift of a five-year term income interest, makes a further gift one year later by extending the donee's interest from a five-year term to a fifteen-year term, the second gift is the gift of a future interest, because the donee's enjoyment of the income from that second gift will not commence until four years after the gift was made.[38]

The *Fondren* opinion, in defining future interest, speaks of a barrier of "a substantial period" between the will of the beneficiary to enjoy the gift and the beneficiary's actual enjoyment.[39] Yet in the years since *Fondren,* it has come to be understood that the slightest degree of postponement of enjoyment will disqualify an income interest for present interest treatment. In *Hessenbruch v. Commissioner,*[40] for example, a trust beneficiary was not to become entitled to receive income distributions until three months after the trust was established. (During that three-month period, the trustee had the discretionary authority to distribute income to the beneficiary but was not required to do so.) Accordingly, it was held that the beneficiary's interest was a future interest, since the beneficiary did not have a right to the *immediate* use or enjoyment of the income. Postponements of a mere one and one-half months[41] or two months[42] have likewise been held to transform what would otherwise have been a present interest into a future interest.[43] However,

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Accordingly, it was held that the gift to *B* was of a present interest. *But see* Newmaker v. Commissioner, 12 T.C.M. (CCH) 232 (1953); Downey v. Commissioner, 11 T.C.M. (CCH) 203 (1952), where similar informal "in trust for" arrangements were held, because of the donors' apparent intentions, to be future interests.

36. United States v. Pelzer, 312 U.S. 399 (1941); Commissioner v. Glos, 123 F.2d 548 (7th Cir. 1941); Hopkins v. Magruder, 122 F.2d 693 (4th Cir. 1941); McManus v. Commissioner, 40 T.C.M. 866 (1980), *aff'd,* 698 F.2d 1221 (6th Cir. 1982).

37. Commissioner v. Brandegee, 123 F.2d 58 (1st Cir. 1941).

38. Rev. Rul. 76-179, 1976-1 C.B. 290. If instead, the donor's second gift to the donee had been the donor's reversionary interest, and if under local law the term of years and reversion thereupon merged so that the donee, as a result of the second gift, acquired full absolute ownership of the property, then the second gift would be a present interest. Clark v. Commissioner, 65 T.C. 126 (1975), *acq.,* 1977-1 C.B. 1. *But see infra* note 339.

39. *See supra* text accompanying note 29.

40. 178 F.2d 785 (3d Cir. 1950).

41. Estate of Jardell v. Commissioner, 24 T.C. 652 (1955).

42. Braddock v. United States, 1973-2 U.S.T.C. 12,963 (N.D. Fla. 1973).

43. In Rev. Rul. 67-172, 1967-1 C.B. 276, the IRS ruled that a grantor of real property, by coupling the grant with a temporary reservation of surface rights (rents and crops), postponed the donee's use and enjoyment and therefore gave only a future

customary administrative provisions whose purpose is simply to provide a convenient distribution procedure—e.g., a provision stating that income is to be distributed only once a year—will not cause an income interest to be treated as a future interest even though the effect of such a provision may be to postpone distributions in particular instances.[44] After all, it is impossible for a trustee to distribute every dollar of income the very instant it is received.

Recently, the Tax Court has departed from the logic of cases like *Hessenbruch.* In *Estate of Grossinger v. Commissioner,*[45] a grantor established a trust whose trustees were directed to make periodic payments to *B,* but such payments were not to begin until the death of *A.* One of the issues in the case was whether the gift to *B* qualified for the annual exclusion, for *A* died only one day after the trust was established, making the degree of postponement in the case of *B*'s gift very small indeed. The court, after citing authority for the commonplace proposition that tax law is concerned more with substance than with form, concluded that *A*'s "life estate had, in substance, ended on the date of creation of the trust,"[46] and that *B* had therefore received the gift of a present interest. Although this decision has a certain intuitive appeal, it is difficult to defend logically, given the clear precedential weight of cases like *Hessenbruch.* The court tried to bolster its decision by noting that *A*'s death was "known to be imminent" on the date the trust was executed.[47] That may be so, but the fact remains that *A* was alive on the date the trust was created, and individuals do not always die when they are expected to. What is crucial is whether *B* received, at the instant of the gift, a right to the immediate use or enjoyment of the property or income therefrom, *not* whether *B*'s use or enjoyment in fact began, as things turned out, almost immediately. Suppose *A* had been twenty-five years old and in perfect health at the time the trust was established. The reasoning of the *Grossinger* court strongly suggests that in that case *B*'s interest would not be treated as a present interest, even if the young and healthy *A* died one day later. In this latter case, such future interest treatment would be sound, but for the difference in result to turn upon the health of the first life tenant is clearly un-

interest. *See* Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); Howe v. United States, 142 F.2d 310 (7th Cir. 1944), *cert. denied,* 324 U.S. 841, *rehearing denied,* 324 U.S. 886 (1945); Commissioner v. Brandegee, 123 F.2d 58 (1st Cir. 1941); Nelson v. Commissioner, 46 B.T.A. 653 (1942).

44. Commissioner v. Kempner, 126 F.2d 853 (5th Cir. 1942); Edwards v. Commissioner, 46 B.T.A. 815 (1942), *aff'd on another issue,* 135 F.2d 574 (7th Cir. 1943).

45. 44 T.C.M. (CCH) 443 (1982), *aff'd on another issue,* 723 F.2d 1057 (2d Cir. 1983).

46. 44 T.C.M. at 454.

47. *Id.* at 453.

sound. We have seen that one of the purposes of limiting the annual exclusion to gifts of present interests is to deny this tax benefit to tax-motivated gifts, the assumption being that gifts of future interests are so motivated.[48] Since the motive exists, if at all, at the instant the gift is made, the classification of the interest should be made as of that same instant.[49]

B. *Valuation of Income Interests*

1. Actuarial Tables

Even if an income interest is a present interest—that is, even if the donee receives an unrestricted right to the immediate use, possession, or enjoyment of a certain share of trust income—the income interest will not qualify for the annual exclusion unless the interest has an ascertainable value as of the date of the gift.[50] Because the annual exclusion is limited to the actual value of the present interest in cases where that value is less than $10,000, the donor must be able to establish that the present interest indeed has value before he may properly claim the exclusion.[51] But the dollar amount of income from investments cannot be precisely forecast; rents, dividends, indeed practically all kinds of income are subject to fluctuation and lapse.[52] How, then, is the value of an income interest to be ascertained?

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48. *See supra* text accompanying notes 20-23.

49. This proposition can also be derived from the more fundamental rule that the federal gift and estate taxes are taxes upon the act of transferring property and that, consequently, the incidence and amount of tax with respect to a transfer must be determined in accordance with the facts existing at the moment of the transfer. The fundamental rule is perhaps most lucidly illustrated in the context of valuation cases: for example, Ithaca Trust Co. v. United States, 279 U.S. 151 (1929) (Holmes, J.), where a husband had established a trust for the benefit of his wife for life, remainder to charity. His executor claimed a charitable deduction for that remainder on the husband's estate tax return. Obviously, the longer the wife's remaining life expectancy as of the valuation date, the smaller the value of the remainder and the smaller the deduction. In fact, the wife died less than one year after the husband (and prior to the due date of the estate tax return), and the executor claimed that the remainder should be valued by taking the wife's early death into account. The Court disagreed, holding that the remainder must be valued using the wife's remaining life expectancy as of the date of the husband's death, without regard to her actual subsequent death. The Court stated that the federal estate tax, like the gift tax, is a tax on what the transferor transfers, not on what the transferee receives.

50. Herrmann's Estate v. Commissioner, 235 F.2d 440 (5th Cir. 1956); *accord* Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); LaFortune v. Commissioner, 263 F.2d 186 (10th Cir. 1958).

51. Fischer v. Commissioner, 288 F.2d 574, 577 (3d Cir. 1961); C. LOWNDES, *supra* note 19, § 33.9, at 818-19.

52. Commissioner v. Lowden, 131 F.2d 127, 128 (7th Cir. 1942).

The answer, of course, is that actuarial tables are used to value a transferred income interest. The Treasury Department's tables are based on a ten percent interest rate assumption; that is, it is assumed that the principal of each gift will earn interest at the rate of ten percent, and a discount rate of ten percent is used to calculate the present value of the projected income stream. The tables are based on unisex mortality assumptions.[53] The Treasury's tables have occasionally been challenged on the ground that they are derived from unsound or inapposite assumptions, but such challenges have usually, though not invariably, been unsuccessful.[54] As one court has stated:

> The whole problem of valuing individual life interests by resort to mortality tables is at best a matter of educated guesswork. The courts cannot demand perfection in an area so

53. From 1971 until the 1984 regulations became effective, the Treasury tables used a six percent interest rate assumption and relied on mortality data that distinguished between males and females. *See* Treas. Reg. § 25.2512-9 (1970); T.D. 7077, 1970-2 C.B. 183. In one 1983 case, a district court held that for the Treasury Department to use sex-distinct mortality assumptions in valuing reversions for § 2037 purposes, *see generally* R. STEPHENS, *supra* note 24, at 4.09, constituted sex discrimination prohibited by the due process clause of the fifth amendment. Manufacturers Hanover Trust Co. v. United States, 576 F. Supp. 837 (S.D.N.Y. 1983); *cf.* Los Angeles Dept. of Water & Power v. Manhart, 435 U.S. 702 (1978) (holding that an employer had violated Title VII of the Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241, 253, by requiring its female employees, because of their supposedly longer life expectancy, to make larger contributions to a pension fund than male employees in order to obtain the same monthly retirement benefits). In 1984, perhaps with these cases in mind, the Treasury Department issued the current regulations based on unisex mortality assumptions. T.D. 7955, 1984-1 C.B. 40. It may be ironic that Treasury regulations in force prior to 1971 were likewise based on unisex mortality assumptions yet were attacked (unsuccessfully) for failure to distinguish between males and females. *See* McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953). And it is undeniably ironic that after the Treasury Department restored the unisex assumptions in 1984, the *Manufacturers Hanover* case was reversed. 775 F.2d 459 (2d Cir. 1985).

If an income interest is granted for the duration of an individual's life, Table A in Treas. Reg. § 25.2512-5(f) (1985) is used; if the interest is to last for a fixed term of years, Table B in that regulation is used. For example, if a donor transfers $30,000 in trust, the income to be paid to *A* (who is 89 years old at the time of the transfer), remainder to *B* absolutely, then the value of *A*'s life estate is $8,858 (which is $30,000 x 0.029526). Accordingly, the donor will be entitled to exclude $8,858 from his $30,000 gift pursuant to § 2503(b); *B*'s interest, of course, is a future interest and does not qualify for the exclusion.

54. *See* Robinson v. United States, 632 F.2d 822 (9th Cir. 1980); McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953); Koshland's Estate v. Commissioner, 177 F.2d 851 (9th Cir. 1949); Allen's Estate v. United States, 558 F.2d 14 (Ct. Cl. 1977); Roy's Estate v. Commisisoner, 54 T.C. 1317 (1970); Bartman's Estate v. Commissioner, 10 T.C. 1073 (1948). The *Robinson*, *Allen's Estate*, and *Roy's Estate* cases dealt with the valuation of reversions for § 2037 purposes. *See generally* R. STEPHENS, *supra* note 24, at ¶ 4.09[4], [6]. The principle is the same, however. *See* Treas. Reg. § 20.2037-1(c)(3) (1962).

> fraught with speculation and uncertainty. . . . Such discrepancies as may exist will no doubt average out in the long run; and while this may sometimes prove to be unfortunate for individual taxpayers, the discrepancies may have to be suffered in the interest of a simplified overall administration of the tax laws.[55]

On rare occasions, taxpayers have been successful in using an interest rate assumption different from that implicit in the Treasury regulations. The Tax Court has held, however, that a different rate may not be sanctioned unless the result that would be obtained by using the Treasury tables "is so unrealistic and unreasonable that either some modification in the prescribed method should be made . . . or complete departure from the method should be taken, and a more reasonable and realistic means of determining value is available."[56] Under this standard, it is appropriate to use an interest rate assumption lower than the Treasury rate where the evidence clearly establishes that the terms of the trust require the principal to be invested in assets necessarily yielding a lower return than the rate assumed in the regulations.[57] Deviation from the Treasury rate should not be allowed merely because the trust must be invested in assets yielding a *higher* rate; though one can safely assume that a bond will never pay more than its stated interest, one cannot so safely assume that it will never pay less. Defaults are hardly unknown in the world of finance. Nonetheless, there is at least one instance in which a court was persuaded to sanction a higher interest rate assumption (based on the investment record of the particular assets involved) than that implicit in the regulations.[58] There is general agreement that if the trustee has the power to sell the trust's current investments and replace them with others, deviation from the Treasury tables will not be allowed, since any "current" rate of return that might be pointed to by the taxpayer could be altered by a change in the trust's investments.[59] Yet again, one can find instances where courts were persuaded to base a valuation on the current actual rate of return of trust investments, even though that rate

55. McMurtry v. Commissioner, 203 F.2d 659, 666-67 (1st Cir. 1953). "The United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work." Gelb v. Commissioner, 298 F.2d 544, 552 (2d Cir. 1962); *accord* Sinclair Refining Co. v. Jenkins Petroleum Co., 289 U.S. 689, 698 (1933).

56. Weller v. Commissioner, 38 T.C. 790, 803 (1962).

57. Hanley v. United States, 63 F. Supp. 73 (Ct. Cl. 1945); Barlow v. Commissioner, 13 T.C. 760 (1949).

58. Security-First Nat'l Bank of Los Angeles v. Commissioner, 35 B.T.A. 815 (1937).

59. Vernon v. Commissioner, 66 T.C. 484 (1976); Brunswig v. Commissioner, B.T.A.M. (P-H) 40,401 (1940); Continental Illinois Bank & Trust Co. v. Commissioner, 29 B.T.A. 945 (1934); Rev. Rul. 77-195, 1977-1 C.B. 295.

could have been altered by authorized investment changes by the trustee.[60]

Taxpayers have likewise been successful, on rare occasions, in using a shorter life expectancy assumption than that implicit in the Treasury tables, where the shorter life expectancy was due to the demonstrable ill-health of the life tenant or annuitant.[61] For obvious reasons, taxpayers have been unsuccessful in applying a longer life expectancy assumption based on their being unusually healthy for their age.[62] The current IRS position is as follows:

> [T]he current actuarial tables in the regulations shall be applied if the valuation of an individual's life interest is required for purposes of the federal estate or gift taxes unless the individual is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. For example, death is not clearly imminent if the individual may survive for a year or more and if such a possibility is not so remote as to be negligible.[63]

2. Fluctuations in the Number of Trust Beneficiaries

One type of case in which the availability of the annual exclusion depends on a well-founded valuation of the transferred interest is that involving a trust the number of whose income beneficiaries may change. Because fluctuations in the number of income beneficiaries occasion corresponding fluctuations in each donee's share of the income, the annual exclusion will be jeopardized if the valuation problem cannot be solved. The now-customary approach to this problem was devised in *Lowden v. Commissioner.*[64] There, a grantor had established a trust that was to make certain payments annually

60. Huntington Nat'l Bank v. Commissioner, 13 T.C. 760 (1949); Security-First Nat'l Bank of Los Angeles v. Commissioner, 35 B.T.A. 815 (1937). In the *Huntington* case, the court noted that a shift by the trustee to higher-yielding investments would have been imprudent for stated reasons; it is not clear, however, whether the court's decision regarding valuation was based on this prudence factor.

61. Butler's Estate v. Commissioner, 18 T.C. 914 (1952); Jennings v. Commissioner, 10 T.C. 323 (1948); Denbigh's Estate v. Commissioner, 7 T.C. 387 (1946); *see* Lion's Estate v. Commissioner, 438 F.2d 56 (4th Cir.), *cert. denied*, 404 U.S. 870 (1971).

62. Dunigan v. United States, 434 F.2d 892, 894 (5th Cir. 1970).

63. Rev. Rul. 80-80, 1980-1 C.B. 194, 195. For an interesting valuation case in which it was the IRS, rather than the taxpayer, that strove unsuccessfully to apply shorter life-expectancy assumptions (premised on an annuitant's supposed ill-health) than those set forth in the Treasury tables, see Estate of McDowell v. Commissioner, 51 T.C.M. (CCH) 319 (1986).

64. 131 F.2d 127 (7th Cir. 1942), *affirming*, B.T.A.M. (P-H) 40,309 (1940).

to each of his four sisters for life, and any income remaining each year after the payments to the sisters was to be paid to each of the grantor's children (then living) for life. The IRS argued that the gifts to the children of the income they were to begin receiving immediately did not qualify for the annual exclusion; because the amount of each child's share of the income depended on the number of sisters who were alive at any time, and because that number was subject to fluctuation, the IRS urged that the interests of the children were not susceptible of valuation. The court held for the taxpayer, however, noting that although an exact or even an actuarially sound value could not be assigned to each child's interest, it was clear that each child's interest had a value in excess of $5,000, which was the amount of the annual exclusion at the time. As long as a donee's present interest was worth at least $5,000, the donor would be entitled to a full annual exclusion for the gift to that donee, since the amount of the exclusion was the *lesser* of $5,000 or the value of the gift to the donee.

This "minimum value" approach to the problem of valuing present interests when the number of donees can fluctuate is certainly sound; but the *Lowden* case was an easy taxpayer victory because fluctuations (that is, fluctuations in the number of living sisters) could only *increase* each child's income share. If the present value of a child's income interest was over $5,000 at the time when all four sisters were alive, the child's interest manifestly qualified for the full $5,000 exclusion. A more difficult case is presented when fluctuations in the number of beneficiaries can decrease a donee's income share. The IRS addressed this case in Revenue Ruling 55-679,[65] issued at a time when the amount of the exclusion was $3,000. A grantor had transferred more than $2 million in trust for a ten-year term. The income was to be paid quarterly in equal shares to such of the grantor's grandchildren as should be living when each income payment came due. (If a grandchild died during the term, the grandchild's living issue were to enjoy his share of the income per stirpes.) At the time the trust was established, the grantor had four children, all of whom were married, and ten grandchildren. The question was whether the gifts to the grandchildren qualified for the annual exclusion.[66]

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65. 1955-2 C.B. 390.

66. Each grandchild living at the establishment of the trust had an income interest lasting until the earlier of: (i) the grandchild's death, or (ii) the expiration of ten years. Such an interest is a present interest, for the same reason that a life estate or term of years is a present interest, but it cannot be valued using the simple tables designed to value life estates or terms of years. The interest is worth less than a life estate, because the interest terminates after ten years even if the grandchild is still living at the

In answering this question, the IRS assumed as a possibility that there could be fifty additional grandchildren born during the ten-year term, for a total of sixty income beneficiaries. If the oldest grandchild living (that is, the grandchild with the shortest remaining life expectancy) at the creation of the trust was twenty-one years old,[67] then the present value of his interest in one-sixtieth of the income would be $9,616.04. Any other grandchild, having a longer remaining life expectancy, would have a more valuable interest. The IRS considered the "worst case"—the oldest grandchild living at the creation of the trust having eventually to share the income with fifty-nine other grandchildren—and showed that even the value of the present interest in that worst case exceeded $3,000. Therefore, each of the ten living grandchildren's present interest was worth at least $3,000, and the grantor was accordingly entitled to ten annual exclusions, even though the number of eventual donees was not ascertainable and the present interest of each donee was consequently not susceptible of valuation.

The IRS attempted to set forth a general rule in a companion revenue ruling:

> [I]f after taking into consideration *all possible future contingencies,* it can be shown that the present interest given has some ascertainable value, based upon sound actuarial principles, then the exclusion is allowable to the extent of the minimum value of such interest, or $3,000, whichever is the lesser. In such cases it is not necessary that the exact value of the gift of the present interest in the property be [actuarially] determinable . . . .[68]

But what is the meaning of "all possible future contingencies?" In Revenue Ruling 55-679, it was theoretically possible for there to be more than sixty grandchildren, if there were adoptions or if births occurred every nine months and some of the births were multiple births. How did the IRS arrive at the number sixty? Did it consider only those possibilities that were statistically most likely to occur? That could hardly have been the case, since sixty grandchildren must surely be a statistical anomaly even in the most prolific families. It is likely that the IRS simply estimated the maximum number of grandchildren that might be born, arbitrarily ignoring the possi-

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expiration of the term. The interest is also worth less than a ten-year term of years, because any grandchild, regardless of his life *expectancy,* could conceivably die before the expiration of the term.

67. The IRS does not expressly state that the oldest living grandchild was twenty-one years old at the time the trust was established; rather, it uses words suggesting that such age was simply a convenient assumption. I assume for our discussion, however, that the oldest grandchild was indeed twenty-one years old.

68. Rev. Rul. 55-678, 1955-2 C.B. 389 (emphasis added).

bility of multiple births or adoptions. The "minimum value" approach applied in *Lowden*, for all its artfulness, requires for its application a good deal of imagination: a faculty that is ordinarily suppressed in tax matters. Yet to refuse to apply the "minimum value" test on the ground that the results it yields are based on arbitrary assumptions would deny exclusions for what is surely a very common trust: one in which after-born beneficiaries are to share in income.[69]

3. Trusts Whose Corpora Consist of Non-Income-Producing Property

Another class of cases in which the availability of the annual exclusion turns on income interests' susceptibility of valuation is that involving trusts whose corpora consist of non-income-producing property. The IRS takes the untenable position that a life or term interest in a trust whose corpus is non-income-producing does not qualify for the annual exclusion. In earlier years, courts rejected this position with little effort,[70] as though it scarcely merited serious consideration, but more recently courts have been treating it with a

69. *Compare* Rev. Rul. 75-506, 1975-2 C.B. 375, where a trust was administered in two equal shares; each of two beneficiaries was to receive for life the income from his half-share of the trust principal. The trust further provided that upon the death of one beneficiary, the two shares of principal were to be combined into a single fund, and the surviving beneficiary was to receive for the remainder of his life all the income from the combined fund. The IRS ruled that the gift in trust comprised a gift to each beneficiary of a present interest in the income from his individual trust share and a gift to the survivor of a future interest in the income from the predeceased beneficiary's share. The latter income interest was held to be a future interest because it did not commence until a future event: the death of a beneficiary.

70. *E.g.*, Commissioner v. Kempner, 126 F.2d 853 (5th Cir. 1942); *see* Tidemann v. Commissioner, 1 T.C. 968 (1943). The *Tidemann* case involved a gift in trust of a life insurance policy, where the income beneficiary of the trust was entitled to receive only the dividends payable by the insurer pursuant to the policy. Policy dividends are generally so undependable that one can scarcely regard a life insurance policy as an income-producing asset. Of course, the policy in *Tidemann* was a fully paid-up single premium policy, and such policies tend to pay dividends more regularly than policies purchased through periodic premium payments. Still, though the court acknowledged that premiums under the policy were "not determinable," the exclusion was upheld. *Cf.* Phillips v. Commissioner, 12 T.C. 216 (1949), where a transfer in trust of a non-income-producing life insurance policy was held to create a future interest in the income beneficiary.

In Gilmore v. Commissioner, 20 T.C. 579 (1953), the Tax Court denied an exclusion for a gift in trust on the ground that the trustees' authority to invest in non-income-producing assets rendered the beneficiary's interest a future interest, even though the IRS had not even raised this issue as an objection to the granting of the exclusion. The Sixth Circuit reversed, however:

> [T]he trust gives the donee the absolute right to all income. The fact that there may not be income during a year is not a contingency imposed by the donor. It is the right of the donee to the income, rather than the

bit more deference. The first of these more recent occasions was *Rosen v. Commissioner*,[71] where the donor had transferred in trust shares of publicly traded stock on which no dividends had ever been paid. The beneficiary was to receive all the income from the trust, payable at least annually, until the trust terminated.[72] The IRS conceded that the beneficiary received a present interest but argued that the annual exclusion should nonetheless be denied because the present interest was not susceptible of valuation. The IRS's concession may have been a tactical blunder—the court so regarded it—for the court did not accept the IRS's argument that the interest could not be valued. The court noted that all the cases cited by the IRS as authority for the proposition that a present interest must be susceptible of valuation in order to qualify for the exclusion were cases where "some impediment, power or contingency [stood] in the way of actual receipt of income,"[73] whereas no such impediment or contingency existed in the instant case.

There, of course, the court was not quite correct. There *was* a contingency standing in the way of the beneficiary's actual receipt of income; either the corporation whose stock constituted the corpus had to change its policy of not paying dividends, or the trustees had to exercise their authority to replace the unproductive trust assets with income-yielding assets. *Rosen* held that the present interest did qualify for the annual exclusion (a correct result, as I shall later argue), but in so doing, it too lightly brushed aside the existence of these two contingencies. The court noted that the stock originally transferred in trust was freely marketable, so that there was no impediment to the trustees replacing it with income-yielding assets; but although the trustees could have effected such a replacement, they were under no obligation to do so.[74] Indeed, they were explicitly authorized to retain non-income-producing assets.[75] The court sought to defend its decision with a bit of sophistry:

> accident of whether there is income at any given time, that is the criterion of present interest.

Gilmore v. Commissioner, 213 F.2d 520, 522 (6th Cir. 1954).

71. 397 F.2d 245 (4th Cir. 1968).

72. The facts of the *Rosen* case are presented here in somewhat simplified form for purposes of clarity.

73. *Rosen*, 397 F.2d at 247-48.

74. As we have seen and as we shall see again, an interest is a future interest if the donee's possession or enjoyment depends on the will of another. *See, e.g.*, Fondren v. Commissioner, 324 U.S. 18 (1945); Hamilton v. United States, 553 F.2d 1216 (9th Cir. 1977); Funkhouser's Trusts v. Commissioner, 275 F.2d 245 (4th Cir.), *cert. denied*, 363 U.S. 804 (1960); Commissioner v. Gardner, 127 F.2d 929 (7th Cir. 1942).

75. Although a trustee is ordinarily under a duty to sell unproductive trust property and replace it with property that will yield income for the income beneficiaries, "[t]he

> Only the most unsophisticated investor, certainly not the purchaser of growth stocks, looks to currently established dividend yield to value his *present* interest. Although it is hope for the future that accounts for the investment irony of *present* value inversely proportioned to yield, such hopes are not always long postponed in an era of conglomerate merger. To deny to the taxpayer here the use of the tables is to treat, for tax purposes, the donated income interests as having no value at all.[76]

The court seems to be saying that although the beneficiary's interest is not presently yielding income, the likelihood of future yield is so great that the interest presently has a value. That is true but irrelevant. The mere fact that a donee can find a market for his interest does not mean that his interest is a present interest.[77] A remainder under a trust has a present value—and if the remainder is indefeasibly vested, it may even be marketable—but it is nevertheless a future interest.

The *Rosen* court failed to face squarely the anomaly that results from characterizing an income interest as a present interest. Even if the stocks and bonds that constitute a trust's corpus are currently yielding income, there is nothing to prevent the issuers of the stocks from ceasing to be profitable or the issuers of the bonds from defaulting. Conversely, there is nothing to prevent the board of directors of corporations issuing non-dividend-paying stock from reversing their policy of paying no dividends, and oil might be discovered on land formerly thought to be unproductive.[78] The income yield (or lack of it) of any asset is necessarily subject to uncertainties. Once the IRS concedes, as it has,[79] that an income interest may be a present interest, it is illogical to single out income interests in trusts whose assets are currently unproductive and deny such interests the exclusion. If the use of actuarial tables is the proper method of valuing life estates when assets are currently productive, even where the assets are currently yielding a return lower than that assumed in the tables, then logic demands that use of the tables be proper when the assets are currently yielding no return. Although *Rosen* reached this result on the particular facts of the

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trustee is not . . . under a duty to sell unproductive property if he is . . . authorized by the terms of the trust to retain it." 3 A. SCOTT, TRUSTS § 240.1 (3d ed. 1967).

76. *Rosen*, 397 F.2d at 247.

77. Braddock v. United States, 1973-2 U.S.T.C. 12,963 (N.D. Fla. 1973); Estate of McClure v. United States, 608 F.2d 478 (Ct. Cl. 1979); Blasdel v. Commissioner, 58 T.C. 1014 (1972), *aff'd per curiam*, 478 F.2d 226 (5th Cir. 1973); Hay v. Commissioner, 47 B.T.A. 247 (1942).

78. R. STEPHENS, *supra* note 24, at ¶ 9.04[3][b].

79. *See supra* note 33.

case, it did not reject the IRS's position as categorically as it should have. The door was therefore left open for the IRS to assert its argument in another case, and assert it it did.[80]

Stark v. United States,[81] the next important case, may be the IRS's least justifiable victory in this area. In this case, the donor established a trust for each of his grandchildren, who were income beneficiaries. The corpus of the trust consisted of shares of stock in a closely held corporation that, although still profitable, had not declared any dividends for twelve years prior to the establishment of the trust. The court concluded that because the income interests were not susceptible of valuation—indeed, had no value at all—the donor was not entitled to any annual exclusions. This decision seems wrong, or at least unsatisfactorily reasoned. Although the corporation had not declared dividends for the past twelve years, it had in the past declared them, and it was still profitable. The court seems to have assumed that there would never be dividends in the future. Nor did the court even discuss the extent of the trustee's authority under the trust instrument. Did the trustee have the authority to sell the closely held shares? Was the trustee authorized to hold unproductive assets? Was the trustee *directed* to hold unproductive assets? Evidently, since the court made no mention of the trust terms, it considered such terms irrelevant to its decision. *Stark* is perhaps distinguishable from *Rosen* in that the stock in the *Stark* case was not publicly traded, so that even if the trustee had tried to sell the stock and substitute productive assets therefor, he might have been unsuccessful. But the court in *Stark* made no attempt to relate its decision to the corpus's nonmarketability.

An IRS victory that has provoked more comment is *Berzon v. Commissioner.*[82] The stock in *Berzon,* like that in *Stark,* was not publicly traded; the corporation, though profitable, had paid no dividends. An agreement among the stockholders imposed restrictions on the sale of shares, as a result of which the trustees were unable to sell the shares at will, but these restrictions appear to have played no part in the decision. Instead, the Tax Court simply noted that the trustees were neither directed nor disposed to sell the closely held stock, and the Second Circuit, which affirmed the decision, concluded that the use of the actuarial tables was inappropriate in cases

80. Shortly after *Rosen* was decided, the IRS announced its nonacquiescence. Rev. Rul. 69-344, 1969-1 C.B. 225, 226.

81. 345 F. Supp. 1263 (W.D. Mo. 1972), *aff'd per curiam,* 477 F.2d 131 (8th Cir.), *cert. denied,* 414 U.S. 975 (1973).

82. 63 T.C. 601 (1975), *aff'd,* 534 F.2d 528 (2d Cir. 1976), *acq.,* 1975-2 C.B. 1.

involving non-income-producing assets, since the assumed interest rate implicit in the tables would yield a clearly erroneous result.

And in *Maryland National Bank v. United States,*[83] the Fourth Circuit chose to distinguish its earlier *Rosen* decision. *Maryland* involved a business that had consistently operated at a loss, whereas the corporation in *Rosen* had been profitable but merely chose to retain its earnings. "The trustees [in *Rosen*] intended to hold the stock, although they had authority to sell, because they anticipated that dividends would be paid in the future and the stock would enhance in value. The income component of the gift was currently reflected by the stock's growth."[84] Although this passage from *Maryland* is an accurate summary of *Rosen*'s reasoning, we have seen that such reasoning is faulty, since the beneficiary of the *Rosen* trust would not have had a *present* right to possess or enjoy such growth. But then in *Rosen* the IRS had conceded that the beneficiary had a present interest, and the sole issue was whether the actuarial tables offered a sound method of valuing the interest.

The key to the *Maryland* opinion lies in the following passage:

> The absence of a steady flow of ascertainable income to the beneficiary can result just as surely from a lack of any prospect of income as it can from restrictions on the trustees' power to disburse income. . . . The taxpayer must show that the trust will receive income [in addition to showing] that some ascertainable portion of the income will flow steadily to the beneficiary.[85]

This language goes rather far. It suggests that if the assets transferred in trust are unproductive at the time of transfer, and if, because of local law or the terms of the trust, the trustee is not required to (or if, because of the nature of the trust assets, the trustee is unable to) dispose of those unproductive assets and replace them with income-producing assets,[86] the grantor will not be entitled to an annual exclusion for his gift of the income interest.[87]

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83. 609 F.2d 1078 (4th Cir. 1979).

84. *Id.* at 1081.

85. *Id.* at 1080. The most recent Tax Court case in this area, Calder v. Commissioner, 85 T.C. 713 (1985), simply followed the *Maryland* case and held that an income interest under a trust whose corpus consisted exclusively of paintings was not a present interest for § 2503(b) purposes. The *Calder* decision, however, appears to have resulted from the donor's failure to establish that, in fact, the paintings would yield income, rather than from any notion that paintings are inherently incapable of producing income. Indeed, the court acknowledged that the paintings *could* have yielded income had the trustee rented them out.

86. *See supra* note 75.

87. *Cf.* Priv. Ltr. Rul. 8508002 (Nov. 8, 1984) (dealt with an analogous requirement of an unconditional income right in § 2056(b)(7)(B)(ii)(I)).

Thus *Maryland* can be read as overruling *Rosen*, not merely distinguishing it, since *Rosen* held that the income interest under consideration qualified for the exclusion even though the trustee was not required by law or the governing instrument to dispose of the unproductive assets. I would reassert that because it has been conceded that an income interest under a trust can qualify for the annual exclusion, logic demands that availability of the exclusion not depend on the nature of the trust assets. This view was expressly sanctioned some years ago[88] but expressly rejected somewhat more recently;[89] and it must be admitted that the cases permitting the use of a lower interest rate assumption than that used in the IRS's actuarial tables when it can be proved that the corpus will in fact yield income at that lower rate,[90] are certainly inconsistent with my view.

C. *Outright Gifts vs. Gifts in Trust*

The IRS takes the position that an outright gift of a bond, note, or life insurance policy is the gift of a present interest, even if the asset yields no income until maturity.[91] Yet as we have seen, it takes the position that if an unproductive asset is given in trust, the life beneficiary of such a trust has been given a future interest.[92] Why the difference?

One commentator has suggested the following as an explanation for the IRS's position regarding the outright gifts: "The theory is that a bond or note has a present value which can be realized by the donee, apart from any income payable thereon, and even though the principal amount does not ripen into a right to payment until the future."[93] The difficulty with this explanation is that the mere fact that a donee can sell his interest does not mean that the interest is a present interest;[94] for example, an indefeasibly vested remain-

88. Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954), *rev'g* 20 T.C. 579 (1953). *See* the discussion of this case *supra* at note 70.

89. Stark v. United States, 345 F. Supp. 1263, 1265 (W.D. Mo. 1972), *aff'd per curiam*, 477 F.2d 131 (8th Cir.), *cert. denied*, 414 U.S. 975 (1973).

90. Hanley v. United States, 63 F. Supp. 73 (Ct. Cl. 1945); Barlow v. Commissioner, 13 T.C. 760 (1949). *See supra* text accompanying note 57.

91. Treas. Reg. § 25.2503-3(a) (1983).

92. In addition to the cases discussed *supra* at text accompanying notes 70-72, see Phillips v. Commissioner, 12 T.C. 216 (1949), disallowing exclusions for gifts of income interests in non-income-producing life insurance policies.

93. J. KRAHMER & J. BURKE, GIFTS—DETERMINATION OF TAX, 176-3D TAX MANAGEMENT PORTFOLIO A-12 (1984).

94. Braddock v. United States, 1973-2 U.S.T.C. 12,963 (N.D. Fla. 1973); Estate of McClure v. United States, 608 F.2d 478 (Ct. Cl. 1979); Blasdel v. Commissioner, 58 T.C. 1014 (1972), *aff'd per curiam*, 478 F.2d 226 (5th Cir. 1973); Hay v. Commissioner, 47 B.T.A. 247 (1942).

der under a trust would probably be marketable but is assuredly a future interest. And conversely, that an interest is nontransferable does not necessarily mean that the interest is a future interest;[95] for example, a spendthrift provision[96] in a trust instrument, which bars the income beneficiary from assigning his income interest, does not cause the income interest to be classified as a future interest.[97] Furthermore, an outright gift of a life insurance policy qualifies for the exclusion even if, because the policy has no cash value at the time of the transfer, there is no present value which can be immediately realized by the donee.[98]

If any logical explanation exists for the difference in treatment between outright gifts of unproductive property and gifts in trust of such property, it is to be found in the very nature of an outright gift.

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95. In Tech. Adv. Mem. 8121003 (Jan. 26, 1981), the IRS took the position that an outright gift of stock in a closely held corporation qualified for the annual exclusion, even though a stockholders' agreement prevented the donee from selling the stock without first offering the corporation and the other stockholders a right of first refusal. Compare this memorandum with Berzon v. Commissioner, 63 T.C. 601 (1975), *aff'd,* 534 F.2d 528 (2d Cir. 1976), *acq.,* 1975-2 C.B. 1, discussed *supra* at text accompanying note 82, which involved a gift *in trust* of shares in a closely held corporation subject to an agreement restricting sales, where the IRS successfully argued that the income beneficiary's interest was a future interest. An important distinction is to be found, however, in the terms of the restrictions. In *Berzon,* the stockholders' agreement effectively barred the trust from selling the shares for some years, *see also* Rev. Rul. 76-360, 1976-2 C.B. 298, while in the memorandum, the shares were simply subject to a right of first refusal, which affected the shares' value but not the power of the donee to sell them.

96. *See generally* 2 A. SCOTT, *supra* note 75, at §§ 151, 152.1.

97. Gilmore v. Commisisoner, 213 F.2d 520 (6th Cir. 1954); Charles v. Hassett, 43 F. Supp. 432 (D. Mass. 1942); Hutchinson v. Commissioner, 47 T.C. 680 (1967); Rev. Rul. 54-344, 1954-2 C.B. 319.

98. Rev. Rul. 55-408, 1955-1 C.B. 113. Although the donee of a policy having no cash value has not received an asset that he can immediately convert to cash, he has received an asset having value for gift tax purposes, since the asset can be retained by the donee until the insured's death and thereupon delivered to the issuer in exchange for the face amount of the policy. The value of the policy for gift tax purposes is ordinarily the sum of the policy's interpolated terminal reserve value and the unearned premium at the time of the gift. *See* Treas. Reg. § 25.2512-6(a), Example 4 (1963).

The owner of a life insurance policy enjoys a number of powers with respect to the policy by reason of such ownership. The power to surrender a policy for its cash value is but one "incident of ownership;" other incidents of ownership include the power to change beneficiaries and the power to borrow against the policy's cash value. *See generally* R. STEPHENS, *supra* note 24, at ¶ 4.14[4]. If a policy has no cash value, some of those possible incidents of ownership will be nonexistent, but others will still exist. In order for the gift of a life insurance policy to qualify for the annual exclusion, the donee must be given the unrestricted right to exercise all such incidents of ownership as may then or thereafter exist. The gift will be a future interest if the donee is precluded from exercising incidents of ownership, Perkins v. Commissioner, 1 T.C. 982 (1943), *nonacq. on other grounds,* 1943 C.B. 38, or if the donee may exercise the incidents of ownership only with the consent of another, Skouras v. Commisisoner, 14 T.C. 523 (1950), *aff'd,* 188 F.2d 831 (2d Cir. 1951).

The Eighth Circuit once observed: "Unless the donee is entitled unconditionally to the present . . . *enjoyment of the property transferred,* the gift is one of a future interest. . . ."[99] Here lies the key. If the property that the donee is enjoying immediately after the transfer is the very property, the very resources, that the donor transferred, then the gift is a present interest.[100] If an asset is given absolutely to the donee, the donee immediately enjoys that asset whether or not it produces income; the gift must therefore be regarded as the gift of a present interest. Otherwise, certain assets would be of such a nature that they could never be the subject of an absolute present gift: a patently absurd result. But if an asset is transferred in trust for the benefit of a donee for life, then the donee cannot presently enjoy the very asset transferred unless he has a credible right to receive income generated by that asset.[101] "The 'property' to which the future-interests provision in section 2503(b) refers in the case of a gift in trust is not the interest in the trust as such but the interest in the property which is entrusted."[102]

The foregoing analysis assumes that one can always recognize when an asset has been given absolutely, but such recognition is not always easy. A bond is not itself wealth; it merely represents the issuer's promise to pay principal and interest at some future time. That the form in which this promise is memorialized is "negotiable" disguises the fact that the form merely represents underlying wealth. If *A* owns a bond and *B* is a beneficiary of a trust, how can we say that *A*'s ownership of wealth is more direct, more "absolute" than *B*'s, particularly if *B*'s interest in the trust is alienable?

The difficulties presented by this confounding problem are illustrated by *Estate of Vose v. Commissioner.*[103] Here a grantor established

99. French v. Commissioner, 138 F.2d 254, 257 (8th Cir. 1943) (emphasis added).

100. It might be objected, in criticism of this formulation, that if *A*, the remainderman under a trust, transfers his remainder to *B* prior to its becoming possessory, *B* has received the very asset *A* transferred and should therefore, by the formulation, be treated as having been given a present interest. The response is that the formulation requires that *B* enjoy immediately after the transfer the very resources that *A* transferred. And in this instance *B* does not enjoy anything immediately after the transfer. The transferred asset by its very nature cannot be enjoyed immediately. It has immediate value, like most future interests, but it is not a present interest because it does not give the holder (*B*) the immediate right to enjoy the resources underlying the interest.

101. The donee might also be found to have a right of present enjoyment if he had the immediate unrestricted power to demand distribution of the asset to himself from the trust. The effect of such powers is examined *infra* at text accompanying notes 270-309.

102. Blasdel v. Commissioner, 58 T.C. 1014, 1022 (1972), *aff'd per curiam,* 478 F.2d 226 (5th Cir. 1973).

103. 18 T.C.M. (CCH) 765 (1959), *rev'd on other grounds,* 284 F.2d 65 (1st Cir. 1960).

an irrevocable trust of which he was the life income beneficiary; he also retained a general power of appointment over the trust exercisable by deed or will. He later gave to certain members of his family, pursuant to the power of appointment, instruments that he termed "certificates of indebtedness." For example, he gave to *X* a certificate of indebtedness having a face amount of $50,000,[104] which entitled *X* to $50,000 of corpus when the trust terminated on the grantor's death and also to interest on that $50,000 at the rate of six percent until the grantor's death. *X*'s certificate of indebtedness thus had the effect of removing the $50,000 of corpus from the reach of the grantor's retained power of appointment. The IRS was willing to concede that *X*'s income interest (that is, the right to receive six percent interest on the $50,000 until the grantor's death) was a present interest qualifying for the annual exclusion; but the taxpayer argued that the amount of the present interest gift was $50,000. That is, he argued that the gift of the certificate of indebtedness was the equivalent of an absolute gift of a $50,000 interest-bearing note. The Tax Court disagreed. It held that *X*'s interest did not amount to a contractual right such as inheres in a bond or note; rather, *X* simply became a beneficiary of the trust to the extent of the $50,000 portion.

> The certificates in issue were issued without consideration. They are payable at some indefinite time in the future. Furthermore, . . . 'the certificates by their terms cannot be transferred or assigned without the written consent of the Trustees.' . . . Respondent's regulations[105] seem to us to have been designed to cover notes and bonds which, although perhaps not containing all of the attributes of negotiable instruments, are at least definitely enforceable legal obligations payable on a day certain and immediately disposable by the obligee.[106]

The Court's conclusion that *X* was given an interest as a trust beneficiary rather than an interest in the nature of a bond[107] was thus based on three factors: (1) the certificate of indebtedness matured upon the grantor's death rather than upon the expiration of a term

104. The individual "*X*" and the $50,000 amount are hypothesized inventions of mine devised to illustrate the workings of this rather complicated arrangement.

105. This is a reference to the regulation cited *supra* at note 91. [Author.]

106. 18 T.C.M. (CCH) at 769.

107. There was a third possible characterization of the certificate of indebtedness; it might have been construed as giving *X* a legal life estate *pur autre vie* (that is, a life estate *pur autre vie* free and clear of any trust) coupled with the remainder. But from the point of view of eligibility for the annual exclusion, there is no difference between the legal life estate analysis and the trust analysis; in each case, only the income or life interest and not the entire $50,000 would qualify for the annual exclusion.

certain; (2) the certificate was not transferable by *X;* and (3) the obligor on the certificate did not receive any consideration for having undertaken the obligation represented by the certificate. As to the first factor, a purported bond or similar instrument is not "negotiable" pursuant to Article 3 of the Uniform Commercial Code unless it is "payable on demand or at a definite time."[108] An instrument that by its terms is payable only upon an event the time of whose occurrence is uncertain, such as a maker's death, does not meet this requirement.[109] However, the *Vose* case arose in Massachusetts prior to that state's adoption of the Uniform Commercial Code.[110] At the time the certificates in *Vose* were issued, Massachusetts' negotiable instruments law provided that a note payable on someone's death was negotiable.[111] Thus, the certificates' failure to mature upon the expiration of a term certain was not fatal to their negotiability under applicable Massachusetts law.[112]

As to the second factor, we have seen that an interest will not be regarded as a future interest merely because the interest is nonalienable.[113] It must be admitted, however, that nonalienability is assuredly not a characteristic of most bonds or notes. The very notion of "negotiability" implies transferability. That the certificate of in-

108. U.C.C. § 3-104(1)(c) (1978). In theory, an instrument that does not meet the U.C.C.'s definition of negotiability may nevertheless be negotiable under some other applicable state law. As a practical matter, however, "it is doubtful that any instrument not in compliance with subsection 3-104(1) will be accepted in commerce as negotiable." 4 W. HAWKLAND & L. LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 3-104:04 (1984) [hereinafter HAWKLAND & LAWRENCE].

109. U.C.C. § 3-109(2) (1978); *see* Rotert v. Faulkner, 660 S.W.2d 463 (Mo. App. 1983).

110. Massachusetts adopted the Uniform Commercial Code effective October 1, 1958. 1957 MASS. ACTS ch. 765. The certificates in the *Vose* case were issued between 1936 and 1943.

111. Massachusetts negotiable instruments law provided that an instrument, to be negotiable, had to be "payable on demand or at a fixed or determinable future time." MASS. GEN. LAWS ch. 107, § 23(3) (1956). And an instrument payable upon the happening of an event the time of whose occurrence was uncertain could still meet that requirement of "determinable future time" if the event was certain to occur (such as an individual's death). MASS. GEN. LAWS ch. 107, § 26(3) (1956).

112. If the Uniform Commercial Code *had* been applicable in *Vose*, the grantor could have met the Tax Court's first objection by presenting *X* with a certificate of indebtedness that recited a definite maturity date. Indeed, since the time of payment under a purported negotiable instrument will meet the U.C.C.'s "definite time" requirement even if the time of payment is subject to acceleration, HAWKLAND & LAWRENCE, *supra* note 108, at § 3-109:04, the grantor in *Vose* could also have met this first objection by presenting a certificate whose maturity date was, say, "twenty years from date of issue or grantor's death, whichever shall first occur." An instrument may likewise meet the "definite time" requirement even if such time is subject to extension at the option of the maker. *Id.* at § 3-109:05.

113. *See supra* text accompanying note 97.

debtedness in *Vose* was not freely alienable adds weight to the argument that the certificate did not amount to the very property that the grantor had given up, but merely represented underlying wealth in the fashion of an interest under a trust. The grantor in *Vose* would have done well to omit the restrictions on alienation from the certificates of indebtedness he transferred.

The third factor, want of consideration, is perhaps the most interesting. The court did not expressly state its reasons for regarding the want of consideration as evidence that the certificate was not in the nature of a bond or note, but we can draw some inferences. The issue in *Vose* was whether the certificate of indebtedness gave the donee a contractual right like a bond or simply made the donee a beneficiary of the trust to the extent of the $50,000 portion. If *A* gives *B* a promissory note purporting to obligate *A* to pay $50,000 to *B* at some future time, but *A* has received no consideration for his promise to pay, then the note is not enforceable by *B*.[114] On the other hand, if *A* announces, "I declare myself trustee of $50,000 for the benefit of *B*," a valid trust enforceable by *B* has been created.[115] Because, in the *Vose* case, the obligor on the certificate of indebtedness (the grantor) received no consideration for the promise to pay,[116] the rights that *X* received would not be enforceable by *X* if the certificate was in the nature of a bond; *X*'s rights would be enforceable only if the certificate made him a beneficiary of the trust. Thus, in construing the transfer of the certificate, the court had to choose between two results: either an ineffective attempt to give *X* an enforceable note, or an effective attempt to give *X* a beneficial interest in a trust.[117] Given courts' natural preference for a construction that yields an effective transfer, we might expect the Tax

114. U.C.C. § 3-408 (1978). If *B* were a holder in due course, *B* could enforce the note notwithstanding the want of consideration, *id.*, but since *B* gave no value for the note, *B* is not a holder in due course. U.C.C. § 3-302(1)(a) (1978).

The *Vose* case arose (under Massachusetts law) prior to that state's adoption of the Uniform Commercial Code. *See supra* note 110. But Massachusetts law in effect prior to the Code likewise held that *B* in our example would be unable, because of the want of consideration, to enforce the note. Drury v. Hartigan, 312 Mass. 175, 43 N.E.2d 660 (1942); Kingsbury v. Ellis, 58 Mass. 578 (1849); Dearborn v. Bowman, 44 Mass. 155 (1841); MASS. GEN. LAWS ch. 107, § 51 (1956).

115. *See* Murray v. O'Hara, 291 Mass. 75, 195 N.E. 909 (1935); Eastwood v. Hayes, 286 Mass. 508, 190 N.E. 796 (1934). *See generally* 1 A. SCOTT, *supra* note 75, at §§ 28-28.1.

116. Although, in form, the trust was the obligor under the certificate, in substance the grantor should be regarded as the person to whom consideration must flow for the certificate to be enforceble as a note, because during his life the grantor had virtually the entire beneficial interest under the trust.

117. *See also supra* note 107.

Court to construe the certificate as giving *X* an interest as beneficiary under the trust.

One can certainly quibble with the *Vose* analysis, but it is difficult to come up with a better one, given the niceness of the distinction between note and trust.

D. *Analogizing Annuities to Income Interests*

The question of annuities is closely akin to the question of life income interests. Suppose a grantor establishes a trust whose trustee is to pay the sum of $2,000 per year to *A* for as long as *A* lives. *A* is sixty years old. Is *A*'s present interest the present value of the entire series of expected periodic payments (about $15,000, using Table B in Treasury Regulation section 25.2512-5(b)) or is it merely the first year's $2,000 payment? One commentator has said:

> A gift of an annuity is a transfer of a present interest, which qualifies for the exclusion, if the annuity payments start immediately to the donee annuitant. In effect this is a gift of a present life estate,[118]

and supporting authority can be found among the older cases.[119] If, however, payments to the donee annuitant are not to commence until some future date[120] or are subject to a contingency,[121] then the transfer of the annuity is the gift of a future interest unless the donee has an immediate unrestricted right to surrender the annuity contract for its cash value.

In *Ream v. Commissioner,*[122] for example, the donor purchased several single-premium annuity contracts, naming other individuals as annuitants. Under some of the contracts, payments to the donees were not to begin until the donor's death; under other contracts, payments to the donees were not to begin until the annuitants' fortieth birthdays (the annuitants were minors at the time of the gifts). The donor argued that these were gifts of present interests, and she cited in support of her position the IRS regulation dealing with

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118. C. LOWNDES, *supra* note 19, § 33.13, at 841.

119. Estate of Kregar, 8 T.C. 1199 (1947); Lowden v. Commissioner, B.T.A.M. (P-H) 40,309 (1940), *aff'd*, 131 F.2d 127 (7th Cir. 1942).

120. Roberts v. Commissioner, 143 F.2d 657 (5th Cir. 1944), *cert. denied*, 324 U.S. 841 (1945); Morrow v. Commissioner, 2 T.C. 210 (1943); Ream v. Commissioner, 12 T.C.M. (P-H) 43,501 (1943), *petition for review dismissed per stipulation*, (7th Cir. 1944).

121. Whittall v. Commissioner, 24 T.C. 808 (1955), *petition for review dismissed*, 230 F.2d 948 (1st Cir. 1956).

122. 12 T.C.M. (P-H) 43,501 (1943), *petition for review dismissed per stipulation*, (7th Cir. 1944).

bonds and notes.[123] But the Tax Court held that these were gifts of future interests:

> It seems to us that [petitioner has] misconstrued the regulation upon which [she relies]. We believe that regulation refers to outright, unconditional gifts of insurance policies, bonds, notes, etc., complete with all the incidents of ownership, which, though they are to be finally discharged by payment in the future, may nevertheless be the subject of a presently effective gift. If [petitioner] had purchased these annuities and presented them to her donees without retaining any intervening interests in or right to the proceeds, and without restricting the present exercise and enjoyment of all the incidents of ownership by the annuitants[,] the situation would then more nearly approximate that intended to be covered by the regulation. . . . She conferred upon [the annuitants] none of the usual present benefits of ownership applicable to insurance or annuity contracts. They could not surrender the contracts for their cash value or borrow against them, and they could not . . . change the beneficiaries or appoint a successor of their own choice to the remainder interests.[124]

But let us return to those cases holding that an annuitant's interest under a trust is a present interest. *Estate of Kregar v. Commissioner*[125] in particular illustrates the extent to which the Tax Court at one time regarded as self-evident the status of annuities as present interests. In this case, the grantor etablished a trust whose trustee was to pay the grantor's wife the sum of $200 per month for her life, and any remaining income was to be paid (presumably at least annually) to each of the grantor's six children for life. The IRS evidently *conceded* that the wife's annuity was a present interest; the issue in the case was whether the children's interests were susceptible of valuation so as to qualify for the exclusion. The court examined the trust property (a commercial building) and the expenses associated with it and concluded that even by the most conservative estimate the building would produce a net income of at least $3,000 per year. After the wife's annuity of $2,400 per year ($200 per month) was subtracted, this left $600 of income or $100 per year for each of the six children. Accordingly, ruled the court, the grantor was entitled to an annual exclusion for the gift to each child, such exclusion to be based on the value of $100 per year for life for each child.

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123. *See supra* note 91.
124. 12 T.C.M. (P-H) at 43,501.
125. Estate of Kregar v. Commissioner, 8 T.C. 1199 (1947).

Is this analogy between an income interest and an annuity interest sound? I have stated earlier in this article[126] that if a donor transfers property and gives a donee the right to receive the income generated by that property, the donee can be said to be enjoying the very property that the donor transferred.[127] But can a donee who receives an annuity under a trust be said with equal justification to be enjoying the very property that the grantor of the trust transferred? In the *Kregar* and *Lowden* cases cited earlier,[128] which held that the series of annuity payments under a trust was a present interest, it was clear from the facts that the annual amount of the annuity would always be less than the annual income of the trust. More particularly, it was clear that the annuity could always, and that the grantor intended that it would always, be paid from the trust income. Instead of granting a $2,000 annuity, the grantor could with the same effect have directed the trustee to pay to the donee each year "either the sum of $2,000, or the income of the trust, whichever should be less."[129] Surely if an immediate income interest is a present interest, the *quality* of that interest is not affected merely because there is a ceiling on the amount that may be distributed in any year; only the *value* of the interest would be affected.[130]

Considering an annuity in terms of its income equivalent may not always benefit the taxpayer. In *Whittall v. Commissioner*,[131] for example, a grantor had in 1947 transferred $67,291 in trust. The trust provided that after certain distributions were made out of income to the grantor's wife and to one of his children,[132] the trust was to pay

126. *See supra* text accompanying note 101.

127. It must be admitted that elsewhere in the Internal Revenue Code, Congress distinguishes between the enjoyment of property and the enjoyment of the income from property. *See, e.g.*, §§ 674(a), 2036(a)(1).

128. *See supra* note 119.

129. I have chosen the figure "$2,000" arbitrarily for illustration purposes. The *Kregar* and *Lowden* cases involved annuities of differing amounts.

Although a $2,000 annuity may have the same effect as an income interest with a $2,000 ceiling in cases where the corpus is sufficient to produce an annual income of $2,000, the two interests are not identical. Under the latter interest, the donee bears the risk of income's dropping below $2,000 in a given year; an annuitant does not bear the risk because the trustee may invade corpus to provide the annuity payments.

130. In Priv. Ltr. Rul. 8204160 (Oct. 30, 1981), a ruling was sought with respect to a trust whose income was to be paid quarterly to each of the grantor's children until each child reached the age of thirty. The trust further provided, however, that not more than $10,000 of income could be distributed to any child in a single year. The IRS ruled that each child's income interest was a present interest and did not even mention the $10,000 ceiling.

131. 24 T.C. 808 (1955), *petition for review dismissed*, 230 F.2d 948 (1st Cir. 1956).

132. The opinion's description of the terms of the trust is quite ambiguous. The better reading of the description is that the trust provided that the payments to the child, which amounted to $6,000 per year, could be made only from income. However,

$200 per year to each of eleven of the grantor's grandchildren. These payments to the grandchildren were to be made first out of the remaining income of the trust, but if such income was insufficient for this purpose, these payments could to that extent be made from corpus. The grantor was permitted to claim an annual exclusion for each of these eleven annuities on his 1947 gift tax return. In 1948, the grantor contributed an additional $96,000 to the same trust, but the Tax Court denied his 1948 claim for another eleven annual exclusions with respect to the annuities. The court noted that the eleven annuities were "fully funded"[133] immediately after the 1947 gift; consequently, the 1948 gift did not increase the value of what the grandchildren received under their annuities. That is, the grandchildren derived no immediate benefit from the grantor's 1948 contribution.

A recent Tax Court case suggests that courts may be less willing than before to analogize annuities to income interests for section 2503(b) purposes. In *Estate of Kolker v. Commisioner,*[134] the grantor had transferred property to an irrevocable trust on December 29, 1976. The trustees were directed to distribute the sum of $3,000 per year to each of the grantor's thirteen then-living children for life. The trust instrument provided that these $3,000 payments were to be made on or about June 13 of each year, and a grandchild had to be alive on each such date in order to be entitled to a $3,000 installment. The grantor on her gift tax return claimed thirteen annual exclusions with respect to this transfer in trust: one exclusion for each grandchild. The IRS denied the exclusions on the ground that the grandchildren received future interests, and the Tax Court agreed with the IRS.

The grantor had maintained that the annuity interest was the equivalent of an income interest. Since an income interest is still a

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the description can be read as stating that the payments to the child could be made out of corpus to the extent income was insufficient. Indeed, the amount of the annual payment guaranteed the child was so large a percentage of the transferred property (almost nine percent) that it is difficult to believe that the trustee was not authorized to invade corpus to produce this amount.

133. *Whittall,* 24 T.C. at 810. Under the terms of the trust, it was quite possible that the trust income would be exhausted in making the required payments to the grantor's wife and child, payments that took precedence over the grandchildren's annuities. *See supra* note 132. If the annuities were paid entirely from the 1947 corpus, the corpus would last for thirty years. These $200 annuities were to be paid until the death of each grandchild's parent who was also a beneficiary of the trust. The opinion does not disclose these parents' ages, so it is difficult to judge whether the court correctly concluded that these annuities were fully funded: that is, whether it was likely that these parents would live for an average of not more than thirty additional years.

134. 80 T.C. 1082 (1983).

present interest even though the beneficiary may be required by the trust instrument to wait until the end of the year to receive the first income distribution, each of these annuities was likewise a present interest, she argued, even though the annuitant had to wait until June 13 (about six months) to receive the first distribution. The court disagreed, saying, in effect, that an income beneficiary *enjoys* his interest immediately and merely has to wait until the end of the year to collect the income; while the annuitant enjoys nothing until a payment is actually made.

> The trust . . . postpones the right to enjoy the trust distributions until June 13 of each year. Before this date, the beneficiaries have no right to demand present enjoyment of the sum. The trust does not create a continuing present right to the income as it is generated. . ., and instead, the trust instrument specifially states that "any income not expended during the fiscal year in which received shall be added to . . . principal." . . . [T]he trust instrument delays the right of enjoyment and requires that each beneficiary survive the postponement period. This plainly creates an interest that will "commence in use, possession, or enjoyment at some future date or time."[135]

There appears to be no sound way of reconciling this case with the earlier cases holding that annuity gifts in trust were present interests. In *Lowden,*[136] for example, the trust instrument expressly provided "that the beneficiaries took no title in the corpus nor in the income until distributed." The court in *Lowden* could therefore have said with no less justification than the court in *Kolker* that the trust instrument "delays the right of enjoyment." Yet this argument never occurred to the *Lowden* court. The court in *Kolker* noted that each annuitant had to wait almost six months (from December 29 to the following June 13) to receive the first annuity payment. Although the courts in *Lowden* and *Kregar*[137] did not discuss the issue of a "waiting period," there is no reason to suppose that there were no waiting periods in those earlier cases. The trust in *Lowden,* for example, provided for the annuities to be paid "annually." The opinion did not specify how these twelve-month intervals were to be reckoned, but it is generally held that when an annuity under a trust is to be paid "monthly" or "annually," the first payment is to be made at the *end* of the month or year following the establishment of

135. *Id.* at 1089.

136. Lowden v. Commissioner, B.T.A.M. (P-H) 40,309 (1940), *aff'd,* 131 F.2d 127 (7th Cir. 1942); *see supra* text accompanying note 119.

137. Estate of Kregar v. Commissioner, 8 T.C. 1199 (1947); *see supra* text accompanying note 119.

the trust, unless the trust instrument otherwise provides.[138] Thus, the delay in the making of the first payment, a delay that led the *Kolker* court to conclude that the annuities were future interests, was equally to be found in the *Lowden* and *Kregar* cases, which held that the annuities were present interests.

One might conclude from *Kolker* that a donor wishing to make an annuity gift in trust should specify that the first payment is to be made immediately. But why should immediate payment be necessary to preserve the exclusion for annuity gifts when it is not necessary in the case of income gifts? We have seen that an exclusion for an income gift in trust will not be denied merely because the trust provides, for reasons of administrative convenience, that income is to be distributed only once a year.[139] After all, since income-producing assets earn income only over a period of time, the income of a trust one instant after its establishment is generally zero. Thus, *Kolker* cannot be explained solely by the fact that the annuity payments therein were subject to a six-month delay. *Kolker* suggests that there is a fundamental difference between income interests and annuity interests apart from the distribution schedule. It suggests that the donee of an income interest has a continuous interest; the income to which he has a right is constantly accruing, and the delay in distributions (that is, the fact that distributions are made periodically rather than uninterruptedly) is due only to administrative necessity. An annuitant, on the other hand, suggests *Kolker,* receives only discrete "bursts" of wealth periodically and accrues nothing between the bursts.

This suggested distinction appears to have support. It is generally held that annuities are not apportioned. That is, if X is entitled to an annuity of $6,000 per year payable on December 31 of each year, and if X dies on April 30, 1985 (after one-third of 1985 has elapsed), X's personal representative is *not* entitled to one-third of the $6,000 that would have become payable on December 31,

138. Henry v. Henderson, 81 Miss, 743, 33 So. 960 (1903); In re Ferris' Trust, 3 N.Y.2d 70, 143 N.E.2d 505 (1957); Kearney v. Cruikshank, 117 N.Y. 95, 22 N.E. 580 (1889); *see* Rhodes v. Mound City Gas, Coal & Oil Co., 80 Kan. 762, 104 P. 851 (1909). These first three cases involved testamentary trusts and held that the annuities were to begin at the end of the month (or year) following the testator's death. A testamentary trust is deemed to be established on the date of the testator's death; in the case of an *inter vivos* trust, the trust is established on the date it becomes effective (*i.e.*, the date it is funded). Therefore, in applying these cases to *inter vivos* trusts, we simply substitute "effective date" for "date of death" and accordingly conclude that the annuities are to commence at the end of the month (or year) following the effective date of the trust. *See* Jacks v. Monterey County Trust & Savings Bank, 20 Cal. 2d 494, 127 P.2d 532 (1942).

139. *See supra* text accompanying note 44.

1985.[140] *X* must be alive on each December 31 in order to be entitled to a $6,000 payment. On the other hand, an income interest under a trust *is* apportioned if the income beneficiary dies between installment dates; his personal representative is entitled to receive the unpaid income that accrued between the prior installment date and the beneficiary's death, unless the trust instrument provides otherwise.[141]

Before we conclude, however, that *Kolker* was correctly decided, two cautionary notes must be sounded. First, if *Kolker* was correct in regarding an annuity as a series of discrete property interests, then even if a gift annuity is to begin immediately rather than at the end of the month or year, only the first periodic payment, rather than the present value of the series of payments, should qualify for the annual exclusion. Yet, one feels instinctively that neither the courts nor even the IRS would be prepared to go quite so far in limiting the exclusion in the case of immediate annuity gifts.[142] Second, the view that annuites are not apportionable has been soundly criticized.

> Surely it would be more in accordance with the purpose of the settlor in creating the trust to permit apportionment where the annuitant dies in the interval between payment dates. The annuitant will naturally incur expenses from day to day in reliance upon his expectation of receiving the annual payment which he will receive if he lives. If he should happen to die just before a payment is due, his estate might well be unable to pay the debts which he has naturally incurred.[143]

Perhaps for this reason, courts have carved an exception out of the general rule and hold that an annuity *will* be apportioned where the annuity was granted for the support of the annuitant.[144] Indeed, at least one court, persuaded by the reasoning of the above-quoted passage, has held that annuities are apportionable under all circum-

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140. Heizer v. Heizer, 71 Ind. 526 (1880); Pearsall v. John Hancock Mutual Life Ins. Co., 321 Mass. 361, 73 N.E.2d 612 (1947); Kearney v. Cruikshank, 117 N.Y. 95, 22 N.E. 580 (1889); Will of Petit, 246 Wis. 620, 18 N.W.2d 339 (1945); *see* Seattle-First Nat'l Bank v. Brott, 15 Wash. 2d 177, 130 P.2d 363 (1942).

141. St. Mary's Hosp. of Evansville v. Long, 215 Ind. 1, 17 N.E.2d 833 (1938); Old Colony Trust Co. v. Sargent, 235 Mass. 298, 126 N.E. 526 (1920); Phillips Exeter Academy v. Gleason, 102 N.H. 369, 157 A.2d 769 (1960).

142. *See supra* text accompanying note 118.

143. 3 A. Scott, *supra* note 75, at § 238.1.

144. Fidelity Union Trust Co. v. Noll, 124 N.J. Eq. 415, 2 A.2d 328 (1938), *reargument denied,* 125 N.J. Eq, 106, 4 A.2d 379 (1939); Seattle-First Nat'l Bank v. Brott, 15 Wash. 2d 177, 130 P.2d 363 (1942).

stances, unless the governing instrument provides otherwise.[145] And a number of states have enacted statutes abolishing the common law rule and providing that annuities are apportionable.[146] Thus, the analysis in the *Kolker* opinion is manifestly inadequate, since it neither distinguishes the earlier cases nor offers a rule that is analytically sound in all jurisdictions. Whether an annuity can ever be a present interest for purposes of the exclusion is now unclear.[147]

III. Cases Involving Interests Subject to a Condition Beyond the Donee's Control

It is by now axiomatic that where a donee cannot possess or enjoy gift property (or the income therefrom) unless a condition beyond

145. Central Nat'l Bank of Cleveland v. McMunn, 10 Ohio Misc. 1, 228 N.E.2d 349 (1967).

146. 146. *E.g.*, MASS. ANN. LAWS ch. 197, § 27 (Michie/Law. Co-op. 1981); N.Y. ESTATES, POWERS & TRUSTS LAW § 11-2.1 (McKinney 1967); N.C. GEN. STAT. § 42-6 (1984).

147. In the context of the estate tax marital deduction, the United States Supreme Court has held that an annuity interest is wholly analogous to an income interest. Northeastern Pennsylvania Nat'l Bank & Trust Co. v. United States, 387 U.S. 213 (1967). Section 2056(b)(5) provides that where a surviving spouse is bequeathed by the decedent spouse a right to all the income from property, coupled with a certain kind of general power of appointment over such property, the property will qualify for the estate tax marital deduction notwithstanding the so-called "terminable interest rule." *See generally* R. STEPHENS, *supra* note 24, at ¶ 5.06[7], 5.06[8][b]. In the *Northeastern* case, the decedent had bequeathed some property in trust. His widow was to receive $300 per month until the decedent's youngest child reached age eighteen, and $350 per month thereafter for life. In addition, the widow was granted a general power to appoint the entire corpus by will. If the will had instead granted the wife a right to, say, one-third of the income (plus the general power over corpus), the IRS would no doubt have conceded that the decedent was entitled under § 2056(b)(5) to a marital deduction equal to one-third of the trust property. But in the case of this annuity, the IRS denied the deduction on the ground that the widow's income interest was not a right to the income "from a specific portion" as required by § 2056(b)(5). The Supreme Court disagreed, holding that one should compute, using the normal actuarial tables, the amount of principal required to produce the monthly amounts stipulated in the trust instrument; and that amount of principal would be the "specific portion" that qualified for the marital deduciton. *Northeastern*, 387 U.S. at 225.

Having thus brought up the subject of the *Northeastern* case, I must admit that the case was probably wrongly decided, *not* because the analogy between annuities and income interests is *per se* unsound, but rather, because the Court overlooked one of the features of § 2056(b)(5). In order for a specific portion of trust property to qualify for the marital deduction pursuant to § 2056(b)(5), the surviving spouse must be "entitled for life to *all* the income" from that portion (emphasis added). If we assume (to simplify matters) that the widow in *Northeastern* was entitled to $300 per month for life, then under the Supreme Court's reasoning the decedent would be entitled to a marital deduction of $60,000, since that is the sum necessary to produce $300 of income per month ($3,600 per year) at the six percent interest rate then implicit in the tables. But it cannot be said that the trust guarantees the widow *all* the income from that $60,000 portion. Conceivably, that $60,000 portion might produce more than $3,600 in a given year, yet the widow would be entitled to only $3,600.

his control is satisfied, the donee's interest is classified as a future interest.[148] Thus, if a donee's entitlement to income or property depends on the consent of another, the donee's interest is a future interest.[149] Likewise, if the donee's entitlement to income or property can be extinguished by the discretionary act of another, the exclusion will be denied on the ground that his interest is incapable of valuation.[150]

Of all the cases dealing with these conditional interests, perhaps the most troublesome—certainly the most numerous—are the cases dealing with income interests under trusts where the trustee's obligation to distribute income is discretionary. In those extreme cases where the trust instrument grants the trustee such absolute discretion as to authorize him to accumulate income (that is, to withhold income distributions) even when the income beneficiary is in need, courts have had little difficulty concluding that the income beneficiary's interest is a future interest.[151] Such conclusions are undoubtedly correct as a matter of tax law, though one could wish that courts inquired a bit more deeply whether, as a matter of trust law, the trustee's discretion was indeed as absolute as the trust instrument purported to make it. Even the use in a trust instrument of such terms as "absolute" or "uncontrolled" does not confer unlimited discretion on a trustee.[152] In most jurisdictions, a trustee whose discretionary powers are purportedly absolute is nonetheless barred from acting dishonestly or arbitrarily or from motives other than the accomplishment of the trust's purposes, though he is not required to act "reasonably" and thus may not be compelled by a

148. Fondren v. Commissioner, 324 U.S. 18 (1945); Hutchings-Sealy Nat'l Bank v. Commissioner, 141 F.2d 422 (5th Cir. 1944); Commissioner v. Gardner, 127 F.2d 929 (7th Cir. 1942); Wood v. Commissioner, 16 T.C. 962 (1951).

149. Fondren v. Commissioner, 324 U.S. 18 (1945); Ryerson v. United States, 312 U.S. 405 (1941); Hamilton v. United States, 553 F.2d 1216 (9th Cir. 1977); Skouras v. Commissioner, 188 F.2d 831 (2d Cir. 1951); Commissioner v. Gardner, 127 F.2d 929 (7th Cir. 1942); Roderick v. Commissioner, 57 T.C. 108 (1971); Wood v. Commissioner, 16 T.C. 962 (1951).

150. Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir.), *cert. denied*, 393 U.S. 953 (1968); Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); Evans v. Commissioner, 198 F.2d 435 (3d Cir. 1952); Bristol v. Welch, 45 F. Supp. 676 (D. Mass. 1942); Priv. Ltr. Rul. 8213074 (Dec. 30, 1981). In cases where the donee's rights can be extinguished by the discretionary act of another, one cannot establish that the donee's gift nonetheless qualifies for the exclusion merely by demonstrating that the discretionary power was never exercised. Schayek v. Commissioner, 33 T.C. 629, 637-38 (1960).

151. Hutchings-Sealy Nat'l Bank v. Commissioner, 141 F.2d 422 (5th Cir. 1944); Thomson v. Reynolds, 54 F. Supp. 409 (D. Minn. 1944); Konner v. Commissioner, 35 T.C. 727 (1961); *see* Vogel v. United States, 42 F. Supp. 103 (D. Mass. 1941); Treas. Reg. § 25.2503-3(c), Example (1) (1958).

152. 3 A. SCOTT, *supra* note 75, at § 187.

court to exercise those powers like the proverbial "prudent man."[153] On the other hand, it has been said that such a trustee may not be "extravagantly unreasonable."[154] Thus, for example, in *Matter of Stillman,*[155] where trustees were authorized in their "absolute and uncontrolled discretion" to make certain periodic distributions of principal to the income beneficiaries, the court held, in view of the grantor's manifest intent to enhance the quality of these beneficiaries' lives, that the trustees' refusal to make such discretionary distributions was improper and that they could be compelled to make the distributions.[156] Indeed, some courts go so far as to hold that a trust provision purporting to grant uncontrolled and uncontrollable discretion to a trustee is void.[157]

A. *Trustee's Power to Accumulate Income*

With this background in mind, let us turn to a consideration of the gift tax cases dealing with trusts whose trustees are granted a discretionary power, subject to a standard, to make income distributions. It is plain that if the trustee is required to pay out all the income currently, the income beneficiary's interest is a present interest even if the income may be distributed only for specified purposes (such as support and maintenance),[158] and even if the trustee is permitted to distribute income to the beneficiary's parent (where the beneficiary is a minor) for the beneficiary's benefit or expend the income directly for the beneficiary rather than distribute the income outright to the beneficiary.[159] The difficult questions arise when the

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153. In re Sullivan's Will, 144 Neb. 36, 12 N.W.2d 148 (1943); In re Koos' Estate, 269 Wis. 478, 69 N.W.2d 598 (1955).

> Although [the settlor] gives his trustee great freedom of action in the administration of the trust, he surely must intend the qualification that the trustee shall act with some regard to the purposes of the trust and not make decisions which frustrate the accomplishment of the settlor's intent, and that he employ his discretion deliberately and with some thought and not recklessly or capriciously but in a spirit of good faith and honesty.

G. BOGERT, TRUSTS AND TRUSTEES § 560 (Rev. 2d ed. 1980); *see, e.g.*, Vest v. Bialson, 365 Mo. 1103, 293 S.W.2d 369 (1956); Thorman v. Carr, 412 S.W.2d 45 (Tex. 1967).

154. Dundee General Hosp. v. Walker, [1952] 1 All E.R. 896.

155. 107 Misc. 2d 102, 433 N.Y.S.2d 701 (Sur. Ct. 1980).

156. *See also* Stix v. Commissioner, 152 F.2d 562 (2d Cir. 1945) (L. Hand, J.).

157. Keating v. Keating, 182 Iowa 1056, 165 N.W. 74 (1917); Heyer v. Bulluck, 210 N.C. 321, 186 S.E. 356 (1936).

158. Albright v. United States, 308 F.2d 739 (5th Cir. 1962); Munger v. United States, 154 F. Supp. 417 (D. Ala, 1957).

159. Albright v. United States, 308 F.2d 739 (5th Cir. 1962); Commissioner v. Sharp, 153 F.2d 163 (9th Cir. 1946); *see* Snyder v. United States, 134 F. Supp. 319 (W.D.N.C. 1955).

trustee's discretionary authority, though subject to a standard, permits him to accumulate income.

Although there were a few earlier cases,[160] the first important case—indeed, the fundamental case—in this area was the Supreme Court's decision in *Commissioner v. Disston.*[161] The trust instrument in that case directed the trustees to apply, until each minor beneficiary reached the age of twenty-one, such amounts of income as might be necessary for the "education, comfort and support" of such minor, and to accumulate for each minor until he reached the age of twenty-one all income not so needed. The Court held that the minors had received future interests, but because the Court found that there were two possible constructions of the trust instrument's directions to the trustees, it offered two alternative grounds for its decision.

First, the instrument might have meant that the trustee was directed to pay out income to a minor only if the minor *needed* such income for his education, comfort and support; and the trustees, in determining whether such need existed, were to consider each minors' outside sources of support money (such as money from his parents). If that was the meaning of the instrument, said the Court, then each minor's interest was plainly a future interest, the Court noting that the minors' father (who was also the grantor) was amply able to support them without the money in the trust and that "[e]ven in its practical working, the trustees did not find the necessary prerequisites for a steady application of all or any ascertainable part of the income for education, support and maintenance."[162]

On the other hand, the trust instrument might have meant that the trustees were under a duty to apply the income for the minors' support, irrespective of any other sources of funds or support the minors might have, and it is the Court's response to this second possible interpretation that has come to be regarded as the "*Disston* holding." The Court observed that even if the trustees were not to consider the minors' other sources of support money,

> there is always the question [of] how much, if any, of the income can actually be applied for the permitted purposes. The existence of a duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding cir-

160. *E.g.*, Smith v. Commissioner, 131 F.2d 254 (8th Cir. 1942).
161. 325 U.S. 442 (1945).
162. *Id.* at 448.

> cumstances that *a steady flow of some ascertainable portion of income* to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future.[163]

"A steady flow of some ascertainable portion of income." How can one possibly establish, in the case of a discretionary trust, that such a "steady flow" will be forthcoming? The search for ascertainability in the case of a discretionary trust occurs elsewhere in gift and estate tax law. For example, if the grantor of a trust retains the discretion to determine when and in what amounts distributions are to be made to any of three beneficiaries, the establishment of the trust does not constitute a gift for gift tax purposes, even though the grantor cannot reclaim any portion of the trust property, because the grantor has retained dominion and control over the property he placed in trust.[164] On the other hand, if the grantor's retained power of control is a fiduciary power limited by what the IRS calls "a fixed or ascertainable standard," then the gift is complete at the time the trust is established.[165] The following appear to be IRS examples of such standards: "[A] power to distribute . . . for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living. . . However, a power to distribute . . . for the pleasure, desire, or happiness of a beneficiary is not such a standard."[166] The theory behind the exception for fiduciary powers subject to a standard is that a grantor bound by such a standard no longer has "dominion and control" over the transferred property but has only the power to carry out the terms of his original transfer. Similarly, although a grantor who establishes an irrevocable inter vivos trust but retains a discretionary power as trustee to determine who will enjoy the income thereunder is required to include the corpus of the trust in his gross estate pursuant to section 2036(a)(2), such inclusion will not be required where the grantor's power is subject to a fixed or ascertainable standard such as one of those mentioned in the above-quoted passage.[167]

In the two kinds of cases discussed in the previous paragraph, no quantitative determination is necessary; all that is required is the

163. *Id.* at 448-49 (emphasis added).

164. Sanford's Estate v. Commissioner, 308 U.S. 39, *reh. denied*, 308 U.S. 637 (1939); Treas. Reg. § 25.2511-2 (1983). At such time as the grantor exercises his discretionary authority and directs a distribution to be made to a beneficiary, a gift in the amount of the distribution will be deemed to occur, because at the time of distribution the grantor allows the distributed property to pass from his dominion and control.

165. Treas. Reg. § 25.2511-2(c) (1983).

166. Treas. Reg. § 25.2511-1(g)(2) (1983).

167. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

qualitative determination that a fixed or ascertainable standard exists. Consequently, they offer no guidance in dealing with the *Disston* issue of whether an income beneficiary has received a present interest: an issue that, *Disston* tells us, requires the quantitative judgment that the beneficiary is assured, notwithstanding the trustee's discretionary authority, a "steady flow of some ascertainable portion of income." I am not suggesting that *Disston* is wrong; after all, we have seen that an income interest can never qualify for the annual exclusion unless the interest has an ascertainable value as of the date of the gift.[168] I am suggesting that it is difficult to conceive of a truly discretionary trust that will nonetheless assure a quantifiable "steady flow" to the income beneficiary.

In the *Disston* case itself, for example, the Court concluded that the minor beneficiaries were not assured such a "steady flow" and had therefore received future interests. Yet this conclusion seems to have been based simply on the fact that distributions to the minor children were small and were made only in one year of the trust. That hardly seems a solid foundation for such a decision. The trust instrument, unlike the instruments in some later cases, did not purport to grant the trustees "absolute" or "uncontrolled" discretion. Consequently, the trustees' discretionary authority had to be exercised in a reasonable manner; if the trustees failed to distribute to the beneficiaries what a reasonable person would consider necessary for their support,[169] such a failure would be an abuse of the trustees' discretion, and the beneficiaries could compel the trustees[170] to distribute to them the amounts that such a reasonable person would think necessary.[171] If, under local law, the beneficiaries in *Disston* could have compelled distributions from the trust, such a power ought to have been considered by the Court in determining whether they were assured a "steady flow" from the trust.[172] The applica-

168. *See supra* text accompanying notes 50-51.

169. Remember, the Court was assuming in this part of its analysis that the trust instrument provided that distributions were to be made for the beneficiaries' support without regard to any outside sources of funds they might have.

170. The relevant beneficiaries in *Disston* were minors, but it is well established that minor beneficiaries may, represented by a guardian *ad litem*, bring a suit for breach of trust. *See, e.g.*, Carton v. Borden, 8 N.J. 352, 85 A.2d 257 (1952). This point is discussed further in connection with the *Crummey* case *infra* at notes 270-300.

171. Old Colony Trust Co. v. Rodd, 356 Mass. 584, 254 N.E.2d 886 (1970); Stallard v. Johnson, 189 Okla. 376, 116 P.2d 965 (1941); Rinker's Adm'r v. Simpson, 159 Va. 612, 166 S.E. 546 (1932).

172. *See* Crummey v. United States, 397 F.2d 82 (9th Cir. 1968); Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951); Perkins v. Commissioner, 27 T.C. 601 (1956); Estate of Buder v. Commissioner, 25 T.C. 1012 (1956); Rev. Rul. 80-261, 1980-2 C.B. 279.

tion by the *Disston* Court of its own rule was unsupported by any satisfactory analysis.

In a somewhat earlier case, *Fondren v. Commissioner,*[173] the Supreme Court had wrestled with the same issue; but the case was considerably easier, and no quotable rule like the "steady flow" rule emerged from it. In *Fondren,* trusts were established for each of several minor grandchildren of the grantors, and the trustee of each trust had the discretion either to accumulate income or to apply income or corpus for the maintenance, education, and support of the beneficiary. What made the *Fondren* case easy, however, was the following statement in the trust instrument: "It is contemplated . . . that our said Grandson will have other adequate and sufficient means of support, and that it will not be necessary to use either the income or the corpus of the trust estate hereby created to properly provide for his education, maintenance and support . . . ."[174] The extent of the discretion enjoyed by the trustee of a support trust[175] such as that in *Disston* or *Fondren,* depends ultimately on the intent of the grantor.[176] In view of the above-quoted passage from the trust instrument, it was plain that the donees were not intended to have a present interest in the trust.

I have implied that it is difficult to prove that the beneficiary of a discretionary trust will be assured the "steady flow" of income that *Disston* requires; the case law suggests that it is all but impossible, for although one can find numerous post-*Disston* cases holding that the trustee's discretion regarding distributions rendered the beneficiaries' interests future interests,[177] search has revealed only one post-*Disston* case favorable to the taxpayer on this issue.[178] In *Disston* itself, the Court said that the assurance of a "steady flow" could be

173. 324 U.S. 18 (1945).

174. *Id.* at 23.

175. A support trust is a trust whose trustee "is directed to pay or apply trust income or capital for the benefit of a named person, but only to the extent necessary to support him, and only when the disbursements will support him. . . ." G. BOGERT, TRUSTS AND TRUSTEES § 229 (2d ed. 1965).

176. *See* 3 A. SCOTT, *supra* note 75, at §§ 186, 187.

177. Hamilton v. United States, 553 F.2d 1216 (9th Cir. 1977); Street v. Commissioner, 261 F.2d 666 (5th Cir. 1959), *aff'g* 29 T.C. 428 (1957); Rassas v. Commissioner, 196 F.2d 611 (7th Cir. 1952); Hessenbruch v. Commissioner, 178 F.2d 785 (3d Cir. 1950); Duffey v. United States, 182 F. Supp. 765 (D. Minn. 1960); Junger v. United States, 154 F. Supp. 417 (D. Ala. 1957); Roderick v. Commissioner, 57 T.C. 108 (1971); Benton v. Commissioner, 27 T.C.M. (CCH) 332 (1968); Messing v. Commissioner, 48 T.C. 502 (1967); Prejean v. Commissioner, 23 T.C.M. (CCH) 1720 (1964), *aff'd per curiam,* 354 F.2d 995 (5th Cir. 1966); Crane v. Commissioner, 16 T.C.M. (CCH) 12 (1957).

178. Morgan v. Commissioner, 42 T.C. 1080 (1964), *aff'd per curiam,* 353 F.2d 209 (4th Cir. 1965), *cert. denied,* 394 U.S. 918 (1966).

proved either by the terms of the trust instrument or by "outside circumstances."[179] This last phrase seems to imply faintly that the taxpayer can prevail by showing that the beneficiaries' needs will be such as to require the trustee, under the discretionary standard imposed by the trust instrument, to provide the beneficiaries with a "steady flow" of income; and to imply that the taxpayer need not demonstrate that those needs will be so great as to require the distribution of *all* the trust income. But how have these implied principles been applied in practice?

Morgan v. Commissioner,[180] the sole taxpayer victory in this area, was certainly an appealing case. The grantor had provided that a share of a trust was to be maintained for the benefit of a certain seven-year-old institutionalized, mentally retarded girl. More specifically, the trustee was empowered, in his sole discretion, to make such disbursements from the income of the trust share "as [would] best provide for the health, comfort, maintenance and education" of the beneficiary, for life. The grantor claimed a full $3,000 annual exclusion for her gift of income to this young beneficiary. Evidently, the trust share produced about $5,500 of income annually, of which the trustee distributed about thirty percent and accumulated about seventy percent as a reserve for the beneficiary's later benefit. The court upheld the grantor's claim of an exclusion. It interpreted the trust instrument as denying the trustee the authority to withhold income in cases of need but granting the trustee the authority to distribute less than all income currently if less than all was needed. Thus, the trustee had the discretion to determine whether the beneficiary had any "health, comfort, maintenance, [or] education" needs and, if so, how much income was required to satisfy those

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A pre-*Disston* case favorable to the taxpayer—Smith v. Commissioner, 131 F.2d 254 (8th Cir. 1942)—might seem at first glance to involve the same issue. However, a close reading of the very ambiguous opinion reveals that the court construed the trust instrument to *require* the trustee to distribute all the trust income (and, indeed, all the trust property). We, on the other hand, are concerned here with trusts whose trustees are not required to distribute all the trust income if less than all the income is needed to meet the beneficiaries' requirements. (At least one court has stated that *Smith* is no longer good law in view of subsequent Supreme Court action. Glenn v. Pitts, 145 F. Supp. 779, 782 (W.D.S.C. 1956).)

A post-*Disston* case favorable to the taxpayer—United States v. Baker, 236 F.2d 317 (4th Cir. 1956)—might also seem at first glance to raise the same issue as *Disston,* but the trustee in that later case was authorized to administer the trust "as if the Trustee . . . were holding the properties as guardian of the beneficiary." *Id.* at 319. Thus, *Baker* can be regarded as no different from the *Albright* and *Sharp* cases, *see supra* note 159, and in fact the reasoning in *Baker* is similar.

179. 325 U.S. at 449.

180. 42 T.C. 1080 (1964), *aff'd per curiam,* 353 F.2d 209 (4th Cir. 1965), *cert. denied,* 384 U.S. 918 (1966).

needs. Yet the trust instrument in *Disston* was susceptible of the very same construction. Why did *Morgan* reach the opposite result?

The *Morgan* court attempted to distinguish *Disston* (and *Fondren*) by noting that in those earlier cases there had been no showing of any immediate need. In *Morgan,* the beneficiary was mentally retarded and living in a home for retarded children. But is that situation really distinguishable from *Disston?* Children have health, comfort, maintenance, and education needs even if they are not retarded or institutionalized. Moreover, neither *Disston* nor *Morgan* discussed whether, under the terms of the instrument or local law, the trustee was to take into account the beneficiary's other sources of support (e.g., parents) in determining how much trust income was needed.[181] The second distinguishing factor according to the *Morgan* court was that in *Morgan* substantial income distributions were in fact made, but not in *Disston.* This second distinction has more substance. We have seen that the determination whether an interest is or is not a present interest must be made as of the instant the gift is made.[182] However, since valuation issues are sometimes decided on the basis of events that occurred after the date as of which the valuation must be made,[183] it seems not unreasonable to

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181. 2 A. SCOTT, *supra* note 75, at § 128.4.

182. *See* the discussion of Estate of Grossinger v. Commissioner, 44 T.C.M. (CCH) 443 (1982), *aff'd on another issue,* 723 F.2d 1057 (2d Cir. 1983), *supra* at text accompanying notes 45-49.

183. For example, in First Nat'l Bank of Kenosha v. United States, 763 F.2d. 891 (7th Cir. 1985), where real property was to be valued for estate tax purposes as of the date of the decedent's death, the court regarded the purchase price recited in a partnership agreement executed twenty-one months after the date of death as relevant to a determination of the date-of-death value. *Accord* Estate of Shlensky v. Commissioner, 36 T.C.M. (CCH) 628 (1977), where, in dealing with a similar issue, the court regarded the price paid in an arm's-length sale of the property occurring fifteen months after the date of death as the best evidence of the property's value *on* the date of death. (The taxpayer and the government had stipulated that no material changes in circumstances relating to the property had occurred during that interval.)

For federal transfer tax purposes, the value of an asset is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. §§ 20.2031-1(b), 25.2512-1 (1965). Thus, in valuing shares of stock in a closely held corporation, one factor to be taken into account is the estimated future earnings of the corporation. O'Malley v. Ames, 197 F.2d 256 (8th Cir. 1952); Rev. Rul. 59-60, 1959-1 C.B. 237 (§ 4.02(d)).

> The facts existing on the valuation date should, in theory, be the only ones to be taken into account, this being the only information available to a hypothetical willing buyer and seller on that date. However, because . . . past earnings are looked to as an estimate of future earnings, courts having those future earnings available are reluctant to close their eyes to the very results they are trying to predict.

J. KRAHMER, VALUATION OF SHARES OF CLOSELY HELD CORPORATION, 221-2D TAX MANAGEMENT PORTFOLIO A-22 (1985); *see* Mott v. Commissioner, 139 F.2d 317 (6th Cir.

consider post-gift distributions in determining whether, as of the date of the gift, the beneficiary was assured a "steady flow." One must be careful, however, to consider such post-gift distributions only insofar as they shed light on the terms of and intention behind the original transfer.

Disston requires not only that the donee be assured a "steady flow" of income, but also that such steady flow be of an ascertainable portion of income, so that the income interest can be proved to have a determinable value for exclusion purposes.[184] It is on this point that the *Morgan* opinion is notably deficient, for although the court upheld the taxpayer's claim of a full $3,000 exclusion for the gift to the child, the opinion does not even attempt to establish that the child's "steady flow" of income had a present value of at least $3,000 as of the date of the gift. The court noted that during the first nine years of the trust's existence, the trustee paid $14,630.97 of income for the child's benefit. Paid ratably, that sum amounts to about $1,626 of income per year. The present value of such a life income interest for a seven-year-old life tenant is about $40,000 (using the three and one-half percent interest rate assumptions then applicable). A present interest worth $40,000 is clearly entitled to the full $3,000 exclusion, but the *Morgan* opinion contains no discussion of the valuation question.

Is *Morgan* a mere aberration? Will the grantor of a support trust be denied an annual exclusion unless the beneficiaries' circumstances give rise, as they did in *Morgan,* to extraordinary needs? The terms of the support trust in *Messing v. Commissioner*[185] were indistinguishable from those in *Morgan,* yet the Tax Court, speaking only three years after its *Morgan* decision, characterized the interests created by the *Messing* trust as "the classic illustration of a future interest."[186] There was no discussion of the beneficiaries' needs or of any distributions that might in fact have been made.[187] A mere five weeks after its *Morgan* decision, the Tax Court held in *Prejean v. Com-*

1943); Doric Apartment Co. v. Commissioner, 94 F.2d 895 (6th Cir. 1938); Hooper v. Commissioner, 41 B.T.A. 114 (1940), *acq. as to valuation issue only,* 1942-1 C.B. 9.

184. *See supra* text accompanying notes 50-51.

185. 48 T.C. 502 (1967).

186. *Id.* at 514.

187. Evidently, the grantor in *Messing* made no offer of proof that sufficient need existed to assure a steady flow of an ascertainable portion of income. (He simply argued, unsuccessfully, that because of a scrivener's error, the trust instrument did not accurately reflect his intention to convey a present interest.) However, the court's characterization of the trust as a "classic" future interest suggests that any such offer of proof would have been rejected as irrelevant.

missioner[188] that the donee beneficiaries[189] of a trust whose trustees had the discretion to distribute income "as [the beneficiaries'] needs . . . may . . . appear" had received future interests, even though there had in fact been substantial income distributions to donee beneficiaries. Why was the result in *Prejean* different from that in *Morgan?* Is the power to distribute income to meet beneficiaries' "needs" more limited than the power given to the trustee in *Morgan* to distribute income for the beneficiaries' "health, comfort, maintenance, and support?" Conceivably, the power *is* more limited; "needs" suggests minimum requirements, while "comfort" and "maintenance" suggest a reference to the beneficiaries' established (and presumably ample) standard of living. But the difference between the two distribution criteria may relate only to the amount of the distributions and not to their character. For example, if a beneficiary's "maintenance" requires $500 per month of income distributions while his "needs" require only $300 per month, the difference is only one of value; a guaranteed distribution of $300 per month is no less a present interest than a guaranteed distribution of $500 per month. Perhaps, a trust instrument authorizing distributions for "need" would be interpreted as requiring the trustee to take into account the beneficiary's other sources of funds before making distributions, whereas a trust instrument authorizing distributions for "comfort and maintenence" would not be so interpreted. But all this is speculative, for the opinion in *Prejean,* although characterized by the Fifth Circuit as "well written,"[190] contains none of the analysis that *Morgan* illustrates (and that *Disston* suggests is necessary) to support its conclusion that the interests were future interests.[191] The mere fact that, under the terms of the instrument, the trustees might properly make no distributions to a particular beneficiary in a given year was enough, suggested the court, to render each beneficiary's interest a future interest. This analysis seems plainly inconsistent with *Morgan,* since the trust instrument in that earlier case likewise empowered the trustee, in the

188. 23 T.C.M. (CCH) 1720 (1964), *aff'd per curiam,* 354 F.2d 995 (5th Cir. 1966).

189. The term "donee beneficiaries" is used to exclude the grantor, who had designated herself a beneficiary as well.

190. Prejean v. Commissioner, 354 F.2d at 996 (5th Cir. 1966).

191. In fact, the trustees in *Prejean* made no distributions to any donee beneficiaries during the first two taxable years of the trust. (Substantial distributions were made, albeit not to all eight of the donee beneficiaries, during the third year.) This telling fact might have served as the basis for the court's decision; the court might have pointed to the lack of distributions in the early years as evidence of the lack of an assured "steady flow." Yet the opinion ignores the lack of distributions; it focuses solely on the terms of the trust instrument and the mere *possibility* that a beneficiary might not receive a distribution in a given year.

exercise of his discretion, to make no distributions of income in a given year.

These Tax Court cases suggest that it is theoretically possible for an income interest under a support trust to qualify for the annual exclusion, but they offer no guidance, no basis for planning transactions in the future. The Third Circuit, on the other hand, in *Hessenbruch v. Commissioner,*[192] though it denied the taxpayer an exclusion, at least offered an interpretation of *Disston* that might serve as a foundation for future planning. *Hessenbruch* suggests that where the grantor does not intend the support trust to serve as the principal source of a beneficiary's support, but intends rather that the trust merely provide marginal incremental benefits to a beneficiary having other means of support, the trust will be regarded as not assuring the beneficiary a steady flow, and the grantor will accordingly be denied an exclusion.[193] This holding, at least, seems a logically sound extension of *Disston.* If a support trust is to make only intermittent income distributions—only on those occasions when the beneficiary's requirements exceed his other resources (or those of his parents)—it is unlikely that distributions will be "steady" or that the amount of income such distributions may represent will be "ascertainable."

Suppose a taxpayer wishes to establish a support trust whose trustee is given the discretion to distribute less than all the income in a given year if less than all is needed to satisfy the distribution standard. How must the trust instrument be written so that the income beneficiary's interest will qualify for the annual exclusion?

192. 178 F.2d 785 (3d Cir. 1950).

193. The court noted:

> It may be assumed that the Trustee's discretion was not absolute, and that [the beneficiary] could have required him, in a proper tribunal, to expend something toward his maintenance, education and support. But at the very least, a showing of need would have been indispensable. . . .
>
> The taxpayer has not attempted to show surrounding circumstances of the kind that would take the case out of the rule of [*Disston*]. Indeed, in view of the trust language, that the income could be used "toward the maintenance, education and support" of the minor, and the fact that the taxpayer was not supporting, or under an obligation to support, him, the inference is that the taxpayer merely wished to contribute to upkeep during minority if the Trustee deemed it necessary or desirable; and there is nothing in the record to warrant the conclusion that the taxpayer regarded the contribution as a necessity.

Id. at 787 (emphasis in original). The first above-quoted paragraph is of extraordinary significance. It suggests that even if the trustee's discretion is not so absolute as to permit him to refuse to make distributions in cases of need, the beneficiary's interest may nonetheless fail to qualify for the exclusion if, under the standard imposed by the governing instrument, distributions cannot be expected to amount to a steady flow of an ascertainable portion of income.

Little can be recommended with any assurance, because of the paucity of helpful case law, but the following points might perhaps be made:

(1) The standard should authorize distributions for a somewhat wide range of reasons. For example, the beneficiary of a trust whose trustee is authorized to make distributions for the beneficiary's "health, education, maintenance, and support" is more likely to be deemed to have received a present interest than the beneficiary of a trust whose trustee is authorized to make distributions only for the beneficiary's "needs."[194]

(2) The trust instrument should declare that in determining how much income to distribute for the beneficiary's health, education, maintenance, and support, the trustee is not to consider any other sources of funds that the beneficiary might have.

194. The standard, though broad, should nonetheless be specific enough to impose a well-defined duty upon the trustee, so that the beneficiaries could, if the trustee failed to make distributions, compel the trustee to distribute to them such amounts as a reasonable person would think necessary or called for under the applicable standard stated in the instrument. *See supra* text accompanying notes 169-71.

Specificity affords the grantor more latitude in choosing a trustee. If, for example, the trust instrument authorizes the trustee to distribute "such amounts of income as will, in the trustee's discretion, satisfy the desires or provide for the happiness of *A* or *B*," the distribution standard will be regarded by the IRS as so vague that if either *A* or *B* is designated trustee, he will suffer adverse tax consequences. The IRS will regard such a standard as, in a sense, no standard at all. If *A* is designated trustee and chooses to distribute all of a given year's income to himself on the ground that his "desires" for that year require all of that inome, there will be no clear basis in equity for determining that in so doing, *A* has violated his fiduciary duty. Consequently, if *A* is designated trustee, he will be required pursuant to § 678 to pay income tax on all the income (that is, "income" for § 61 purposes) of the trust, *including* the income that is accumulated or distributed to *B*, since, as a practical matter, *A* will have "a power exercisable solely by himself to vest the . . . income . . . in himself." § 678(a)(1). That is, the purported restriction on *A*'s power to distribute income to himself is so indefinite as to constitute no restriction at all. Furthermore, *A*'s power will be regarded as a general power of appointment for gift and estate tax purposes. Treas. Reg. §§ 25.2514-1(b)(1) (1981), 20.2041-1(b)(1) (1961). Consequently, if *A* distributes any income to *B*, the distribution will be a gift by *A* for federal gift tax purposes, § 2514; and any trust income undistributed as of *A*'s death will be includible in *A*'s gross estate for federal estate tax purposes. § 2041. However, if *A*'s power to distribute income to himself or *B* is expressly limited by a reasonably fixed or ascertainable standard (such as the "education, support, maintenance, or health of the beneficiaries"), then (1) *A* will not be taxed on the trust's income pursuant to § 678, United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960); (2) a distribution of income to *B* will not be regarded as a gift by *B*. Treas. Reg. § 25.2511-1(g)(2) (1983); and (3) trust income undistributed as of *A*'s death will not be includible in *A*'s gross estate, § 2041(b)(1)(A).

(3) The trust instrument should not use words like "uncontrolled" or "unfettered" to describe the trustee's discretionary authority.[195]

(4) The trust instrument should negate any inference that the trustee has the authority to withhold income in instances of real need.

(5) The trustee should make a point of distributing at least some income to each income beneficiary during each calendar year.[196]

These five recommendations are offered with some misgivings, for there was only one post-*Disston* case favorable to the taxpayer, and the unfavorable post-*Disston* cases offer so little cogent analysis. Nonetheless, it is worth observing that in none of the eleven unfavorable cases cited earlier[197] were all five of these recommended features present.

Might not a saving clause succeed in preserving the annual exclusion for the income interest under a support trust? For example, might not the following provision in the trust instrument preserve the exclusion: "Notwithstanding any other provision in the trust instrument, no discretionary power herein granted to the trustee may be exercised by him if the existence of such power would, but for this sentence, cause the income beneficiary's interest to be characterized as a future interest under I.R.C. section 2503(b)?" The answer is probably a negative one, in view of the position the IRS took with respect to charitable remainder trusts before the Tax Reform Act of 1969[198] made the rules more complicated.[199] Prior to the 1969 amendments, if a grantor established a trust whose income was to be paid to an individual for life and whose remainder was to pass to charity, the charitable remainder would not qualify for the gift tax charitable deduction[200] or the estate tax charitable deduction[201] if the trustee was given a discretionary power (e.g., a power to invade corpus for the benefit of the life income beneficiary) that rendered the charitable remainder incapable of valuation at the time

195. *Compare* the discussion *supra* at notes 152-57 (a trustee granted "uncontrolled" discretionary authority by the governing instrument is not circumscribed by any "reasonable trustee" standard) *with* the discussion *supra* at notes 169-71 (a trustee whose authority is not expressly made "uncontrolled" by the governing instrument is required to act as a reasonable trustee would act).

196. *See* Edwards v. Commissioner, 46 B.T.A. 815 (1942).

197. *See supra* note 177.

198. Pub. L. No. 91-172, 83 Stat. 487 (1969).

199. *See* Pub. L. No. 91-172, §§ 201(d)(1), (d)(3), 83 Stat. 560-62 (1969). *See generally* C. LOWNDES, *supra* note 19, § 16.9 at 432-34, § 34.3 at 845-48.

200. § 2522.

201. § 2055.

of the transfer;[202] but the deduction *would* be allowed if the discretionary power was so limited (e.g., a power to invade corpus only to pay the life income beneficiary's medical expenses) as to permit the valuation of the remainder.[203] In Revenue Ruling 65-144,[204] the IRS was asked to rule upon a charitable remainder trust whose trustee had a number of discretionary powers that could arguably have diverted corpus away from the charitable remainderman. The trust instrument provided that any trustee power that was determined to have the effect of rendering the remainder incapable of valuation (and hence non-deductible) would be void. The IRS quite property ruled that this attempt to impose such a condition upon the trustee's discretionary powers was void because it was contrary to public policy.

The IRS's ruling was based on *Commissioner v. Procter,*[205] where a grantor had transferred property in trust on the condition that if any part of the transfer was deemed to be subject to federal gift tax, the property so transferred was to be returned to the grantor. The Fourth Circuit held the condition to be void on public policy grounds. First, the court noted, the condition had a tendency to interfere with the collection of the gift tax, since the only effect of an attempt to enforce the tax law would be the defeat of the gift. Second, the court stated:

> [T]he effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were held valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the va-

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202. Merchants Nat'l Bank of Boston v. Commissioner, 320 U.S. 256 (1943).

203. Ithaca Trust Co. v. United States, 279 U.S. 151 (1929).

> If a trust is created or property is transferred for both a charitable and private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest.
>
> If the . . . trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the [grantor], the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

Treas. Reg. § 20.2055-2(a), (b) (1972).

204. 1965-1 C.B. 442.

205. 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944).

> lidity of the gift[: a controversy] between the donor and persons not before the court.[206]

Thus, if the court held the condition valid and the gift subject to tax, such a holding would mean that the gift by its terms was revoked. Yet such a holding, because it arose out of a suit to which the beneficiaries of the trust were not parties, would not be binding upon them; they might later enforce the gift notwithstanding the holding of the court in the tax suit. "It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained."[207] In view of these authorities, it is unlikely that a saving clause in a discretionary support trust can be used to preserve the annual exclusion.

B. Trustee's Power to Allocate Receipts and Expenses Between Income and Corpus

Suppose the trustee of a trust is directed to distribute all trust income annually to *A* for life and to pay the remainder to *B* free of trust upon *A*'s death. Clearly, *A*'s interest qualifies for the annual exclusion. Suppose instead, however, that the trustee is given the discretion to accumulate income during *A*'s life. In that event, *A*'s interest will be a future interest, since *A*'s receipt of income will be contingent on the consent of another: the trustee.[208] Now let us consider an intermediate case. Suppose the trustee is required to distribute all trust income to *A* but is authorized by the trust instrument to allocate each trust receipt and each item of expenditure either to income or to corpus in his unfettered discretion. It might be argued that the trustee consequently has the authority, by allocating all receipts to corpus or all expenditures to income, to nullify *A*'s income interest, with the result that *A*'s interest should be regarded as a future interest. Similarly if the trustee of the trust described in this paragraph's opening sentence were authorized to sell the income-producing assets originally transferred to the trust and replace them with non-income-producing property, might it not be

206. *Id.* at 827. *See* Rev. Rul. 86-41, 1986-12 I.R.B. 9, where a donor transferred an undivided one-half interest in land on the condition that if the value of the interest for gift tax purposes was ever found to have exceeded $10,000 at the time of the transfer, the donee's fractional interest would be reduced so that its value at the time of transfer equalled $10,000. The IRS ruled that the "adjustment clause" would be disregarded in determining the value of the transferred interest for gift tax purposes.

207. 142 F.2d at 872.

208. *See supra* note 149 and accompanying text. Another reason for characterizing *A*'s interest as a future interest would be that the trustee's power prevents *A* from being assured of "a steady flow of some ascertainable portion of income." Commissioner v. Disston, 325 U.S. 442, 448-49 (1945).

argued that the existence of such a power renders *A*'s income interest unsusceptible of valuation and hence not qualified for the present interest exclusion?[209] The question can be phrased more generally: to what extent will a trustee's administrative powers cause the annual exclusion to be denied for gifts of income interests under the trust?

There have been six cases addressing this issue, of which the taxpayer won four[210] and the government two.[211] The earliest of these cases—*Brown v. Commissioner*[212]—was a taxpayer victory, but the opinion suggested an approach that was taken in most of the subsequent cases and should have been taken in all of them. In *Brown*, the trust instrument granted the trustees "absolute discretion" to allocate receipts (cash dividends, interest, rents) to principal, and the IRS accordingly argued that the life income beneficiaries under the trust had received only future interests. The IRS agrument would at first appear to be unassailable, since an "administrative" power to allocate receipts to principal seems on its face no different from a power to accumulate income. The trustees were also granted the discretion, although the word "absolute" was not used in this regard, to allocate realized gains and losses either to principal or to income. Thus, the IRS urged, the trustees had another method of administratively vitiating the income interests: by allocating all gains to principal and all losses to income.[213]

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209. *See supra* text accompanying notes 70-90.

210. Mercantile-Safe Deposit & Trust Co. v. United States, 311 F. Supp. 670 (D. Md. 1970); Martinez v. Commissioner, 67 T.C. 60 (1976); Quatman v. Commissioner, 54 T.C. 339 (1970); Brown v. Commissioner, 30 T.C. 831 (1958).

There was dictum in an early First Circuit case—Commissioner v. Brandegee, 134 F.2d 58 (1st Cir. 1941)—to the effect that "ordinary" trustee powers over an income interest will not cause that interest to be characterized as a future interest. *Id.* at 61. By "ordinary" the court presumably meant to refer to those trustee powers automatically conferred upon trustees as a matter of state law (in the absence of contrary language in the trust instrument). The particular example that the court offered of an ordinary power was the power "to withhold a reasonable amount of income to meet anticipated expenses which are properly chargeable to income." *Id.* (quoting the RESTATEMENT OF TRUSTS § 182, comment b).

211. Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir. 1968), *aff'g* 272 F. Supp. 571 (E.D. Wis. 1967), *cert. denied*, 393 U.S. 953 (1968); Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961).

212. 30 T.C. 831 (1958).

213. When we speak of allocating realized losses to income, we mean using income to reimburse the principal for the realized losses. For example, if in a given year the trust received income (dividends, interest, rents) totalling $10,000 and in the same year sold for $5,000 an asset it had purchased for $7,000, allocating that $2,000 realized loss to income would mean that only $8,000 of income would be distributed to the income beneficiaries, and $2,000 of income would be added to principal.

The Tax Court held, however, that these trustee powers were intended merely to facilitate the administration of the trust, rather than to confer additional dispositive authority upon the trustees;[214] and such administrative powers could not be used in such a way as to substantially divert trust receipts away from the income beneficiaries, who "could resort to a court of equity to prevent the improper exercise of the powers."[215]

The court's holding regarding the role of state trust law is of paramount importance. Although the term "future interest" in section 2503(b) is a term of federal tax art rather than a term of state property law,[216] the nature of a donee's interest in gift property is determined with reference to state property law. The gift tax is an excise tax upon the transfer of property interests,[217] and the annual exclusion is granted in the case of gifts of certain kinds of property interests. But property interests are created by state law, not federal. Therefore, in determining whether a donor has made a gift qualifying for the annual exclusion, we look to state law to determine the nature and character of the property interest the donee has received; then we look to federal law to determine whether a property interest of such nature and character is a "future interest" for section 2503(b) purposes.[218] Thus, the court in *Brown* quite properly turned to Maryland trust law to determine whether it accorded such rights to the beneficiaries as to bring their beneficial interests under the trust within the federal definition of "present interest."

First, the court satisfied itself that under Maryland law a trustee's discretionary power was subject to control by equity courts to prevent an abuse of discretion.[219] Second, the court concluded that

214. *Cf.* Rev. Rul. 77-358, 1977-2 C.B. 342, where the IRS denied an annual exclusion in the case of a trust whose trustee was *required* to allocate losses to income. *See infra* text accompanying notes 243-45.

One court has used the term "managerial powers" to refer to the kind of powers *Brown* characterized as "administrative" and the term "entrepreneurial powers" to refer to trustee powers over the beneficial disposition of trust assets, Jolly v. United States, 259 F. Supp. 315, 324 (D.S.C. 1966), but such terminology seems never to have gained acceptance.

215. *Brown*, 30 T.C. at 835.

216. United States v. Pelzer, 312 U.S. 399 (1941).

217. Bartman v. Commissioner, 10 T.C. 1073 (1948).

218. "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." Morgan v. Commissioner, 309 U.S. 78, 80 (1940) (estate tax).

219. The Maryland case cited by *Brown* in support of this proposition—Offutt v. Offutt, 204 Md. 101, 102 A.2d 554 (1954)—in fact held that no abuse of discretion had been proved and therefore no judicial intervention was justified. However, Maryland cases certainly do exist in which an abuse of discretion *was* proved and a judicial remedy applied. *E.g.*, Levi v. Bergman, 94 Md. 209, 50 A. 515 (1901).

under Maryland law, if the trustees of the trust at issue were to exercise their discretionary allocation powers in such a way as to deprive the income beneficiaries of their interest, such exercise "would constitute an abuse of discretion which the Maryland courts would prevent."[220]

> A careful reading of the whole indenture of trust indicates that the intention of the settlor was to give the income beneficiaries a substantial present interest and nowhere does it appear that she intended to favor the remindermen to their (income beneficiaries') detriment. It does not appear that the trustees' discretionary powers were granted for any other purpose than to facilitate the administration of the trust.[221]

The Tax Court was unable to find any Maryland case law dealing specifically with this issue of abuse of discretion. However, the court found in Massachusetts case law an illustration of such general American common law on the point as Maryland courts would be likely to adopt. Although the court correctly interpreted Massachusetts law as so limiting the trustees' allocation powers as to preclude the divestment of the income beneficiaries, perhaps the best Massachusetts case to support the *Brown* decision was not decided until about eight years later: *Old Colony Trust Co. v. Silliman.*[222] In this 1966 case, a testator had established a charitable remainder trust whose trustee was granted the discretion to allocate receipts and charges to income or principal. Concerned that the trustee's alloca-

220. *Brown,* 30 T.C. at 837.

221. *Id.* In support of its conclusion that the powers were granted merely to facilitate the administration of the trust, rather than to confer additional dispositive authority upon the trustees, the court adverted to testimony by a trust officer of Mercantile-Safe Deposit and Trust Company:

> The trust officer of Mercantile, which administers numerous trusts and which was the corporate trustee of the trust . . . here involved, testified that similar clauses are contained in about 90 percent of the trusts which Mercantile administers and that Mercantile usually requests such clauses so as to facilitate administration and avoid litigation on doubtful items. He also testified that since the inception of the trust the income beneficiaries have received substantially all of the receipts of the trust estate. In the course of the testimony of this trust officer . . . , the following question and answer appear:
>
> Q What is the purpose of inserting powers of this nature in the trust instrument?
>
> A So that as and when some unusual distribution is received by the trustee it would not be necessary to go into equity for instructions, that we have some area in which we can operate under our discretion to determine what is principal and what is income; not to withhold income but to determine what part of the distribution represents income and what part represents principal.

Id. at 837 n.3.

222. 352 Mass. 6, 223 N.E.2d 504 (1966).

tion powers rendered the remainder incapable of valuation and consequently uncertain whether they could properly claim the charitable deduction on the estate tax return,[223] the executors petitioned the Massachusetts court for instructions as to the nature of the trustee's discretionary powers. The court characterized the allocation power as merely

> authorizing the trustee in instances of doubt to use its best informed judgment in good faith in the light of what the established rules suggest to the trustee is consistent therewith. This is a means of avoiding the expense of litigation. This power may not be used to shift beneficial interests. It does not authorize favoring either the charitable or the private beneficiaries. It is of equal advantage to each in conserving the assets of the trust. *In our view such a power imports no more uncertainty in the ascertainment and calculations of the value of the charitable remainder than does the contingency that the precise amount of administrative charges and of accretions over the years cannot be known in advance.*[224]

The analysis in the other three gift tax cases favorable to the taxpayer on this issue was virtually identical with that in the *Brown* case.[225] But what about the two unfavorable cases? It is virtually impossible to distinguish *Fischer v. Commissioner,*[226] an unfavorable case, from *Mercantile-Safe Deposit and Trust Co. v. United States,*[227] a more recent favorable case, for the two cases involved the very same trustee powers: (1) a power to invest in non-income-producing assets (the assets originally tranferred to the trust were income-producing); (2) a power to allocate expenses to either income or principal; (3) a power to borrow, mortgage, or pledge; and (4) a power to improve, alter, repair, or develop the trust property. Indeed, the trustee powers in *Fischer* were slightly more restricted that those in *Mercantile:* in *Fischer* the trustees' allocation power extended only to expenses, while in *Mercantile* the power extended to both receipts and expenses; and in *Fischer* that allocation power was

223. *See supra* text accompanying notes 200-03.

224. Old Colony Trust Co. v. Silliman, 352 Mass. 6, 10-11, 223 N.E.2d 504, 507-08 (1966) (emphasis added). The Massachusetts Supreme Judicial Court decided a similar case five years later: Worcester County Nat'l Bank v. King, 359 Mass. 231, 268 N.E.2d 838 (1971). The issue was virtually the same as in the *Silliman* case except that in the later case the settlor purported to grant the trustee absolute discretion by inserting the phrase "notwithstanding any rule of law." Nonetheless, the court held that the value of the charitable remainder was presently ascertainable.

225. Mercantile-Safe Deposit & Trust Co. v. United States, 311 F. Supp. 670 (D. Md. 1970) (applying Maryland law); Martinez v. Commissioner, 67 T.C. 60 (1976) (applying California law); Quatman v. Commissioner, 54 T.C. 339 (1970) (applying Ohio law).

226. 288 F.2d 574 (3d Cir. 1961).

227. 311 F. Supp. 670 (D. Md. 1970).

granted "to the extent that [the trustees] could do so [i.e., allocate] legally," whereas there was no such express limitation in the *Mercantile* trust instrument.[228] The other unfavorable case—*Van Den Wymelenberg v. United States*[229]—likewise involved trustee powers identical to those in *Mercantile.*

Despite these considerable similarities, the *Mercantile* court attempted to distinguish *Fischer* and *Van Den Wymelenberg* on three gounds. First, the court observed that a trust of personal property (*Mercantile*) is more certain to yield net income than a trust of real property (*Fischer* and *Van Den Wymelenberg*). This observation is entirely unjustified. Some stock and bond investments can be riskier than some real estate investments; and in fact, the real property in the *Fischer* trust was steadily yielding a net annual income of some $30,000 (about six percent of its fair market value) after the trust was established. Second, the *Mercantile* court observed that local (Maryland) law would be available to correct any abuse by the trustees in the exercise of their discretion. As to this second point, it is true that neither *Fischer* nor *Van Den Wymelenberg* discusses local law, but *Mercantile* offers no basis for supposing that local law in those earlier cases—New York in *Fischer*[230] and Wisconsin in *Van Den Wymelenberg*—would not similarly have been available to correct abuses of discretion. Third, the *Mercantile* court made a seemingly pointless observation:

> The instruments in our case direct that all the income from a particular trust be paid to the life beneficiary of that trust. No income or principal can be paid to anyone other than the income beneficiary during his lifetime. The trusts contain no power permitting the Trustees to accumulate income.[231]

This last observation could likewise have been made about the trusts in *Fischer* and *Van Den Wymelenberg.* The court offers no justification

228. The quoted phrase comes from a passage in the *Fischer* court's opinion describing the trustees' powers: "The trustees were given absolute discretion and authority . . . to charge any expenses or costs against principal or income to the extent that they could do so legally. . . ." 288 F.2d at 575. Thus, it is not altogether clear whether the court, in writing "to the extent . . . legally," was paraphrasing an express restriction in the trust instrument or simply stating the obvious point that the trustees could exercise their powers only to the extent local law permitted. In view of the complete absence of any discussion of local law elsewhere in the opinion, I incline toward the former interpretation.

229. 397 F.2d 443 (7th Cir.), *aff'g* 272 F. Supp. 571 (E.D. Wis. 1967), *cert. denied*, 393 U.S. 953 (1968).

230. Although the grantor and trustees in *Fischer* were domiciled in New Jersey, the corpus of the trust consisted of New York real estate. Consequently, New York law, rather than New Jersey law, would have applied in determining whether the trustees had abused their discretion. *See* 5 A. SCOTT, *supra* note 75, at § 659.

231. *Mercantile*, 311 F. Supp. at 674-75.

for its implication that the income beneficiaries' entitlement to income in *Mercantile* was somehow more overriding than in *Fischer* or *Van Den Wymelenberg.*

With this third observation, however, the *Mercantile* court may have been groping toward a possible ground for distinction. In *Fischer* and *Van Den Wymelenberg,* the income beneficiaries and the remaindermen were the same individuals; the income was to be paid to each beneficiary for a term, and then the corpus was to be distributed to him. On the other hand, in *Mercantile* (and also in *Brown* and *Martinez v. Commissioner*[232]), the income beneficiaries and remaindermen were different individuals. Ordinarily, a trustee has a duty to deal impartially with all beneficiaries:[233] life tenant and remainderman alike.[234] And, barring contrary indications in the trust instrument, the trustee must exercise any discretionary power to allocate receipts or expenditures to income or corpus in a manner consistent with this duty of neutrality.[235] For example, in *Peoples Trust Co. of Bergen County v. United States,*[236] a grantor had created a charitable remainder trust[237] whose governing instrument provided that any capital gains distributions from mutual fund shares owned by the trust were to be allocated to income. Since the trustee was authorized in his absolute discretion to invest in mutual fund shares, the

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232. 67 T.C. 60 (1976).

233. RESTATEMENT (SECOND) OF TRUSTS § 183 (1959).

234. If by the terms of a trust the trustee is directed to pay the income to a beneficiary during a designated period and on the expiration of the period to pay the principal to another beneficiary, the trustee is under a duty to the former beneficiary to take care not merely to preserve the trust property but to make it productive so that a reasonable income will be available for him, and he is under a duty to the latter beneficiary to take care to preserve the trust property for him.

> Although the trustee is not under a duty to the beneficiary entitled to the income to endanger the safety of the principal in order to produce a large income, he is under a duty to him not to sacrifice income for the purpose of increasing the value of the principal. Thus, the trustee is under a duty to a life beneficiary not to purchase or retain unproductive property or property which yields an income substantially lower than that which is normally earned by trust investments, although it is probable that the property will appreciate in value. . . .
>
> On the other hand, the trustee is under a duty to the beneficiary who is ultimately entitled to the principal not to purchase or retain property which is likely to depreciate in value, although the property yields a large income, unless he makes adequate provision for amortizing the depreciation. . . .

Id. § 232 comment b (1959).

235. Mercantile-Commerce Bank & Trust Co. v. Morse, 356 Mo. 336, 201 S.W.2d 915 (1947); In re Thompson's Estate, 262 Pa. 278, 105 A. 273 (1918).

236. 444 F.2d 193 (3d Cir. 1971).

237. *See supra* text accompanying notes 198-200.

IRS argued that the trustee in effect had the authority to divert assets from the charitable remaindermen to the noncharitable life tenant[238] and that the charitable remainder was consequently not susceptible of valuation and therefore disqualified for the estate tax charitable deduction.[239] The court upheld the deduction, however, because it was persuaded that local (New Jersey) law imposed on the trustee a duty of impartiality that would be violated were the trustee to exercise his power to invest in mutual funds in such a way as to unreasonably divert assets from the remainder to the life interest.[240]

In the case of a trust whose income beneficiary and remainderman are the same individual, the duty of impartiality can hardly be said to exist. Consequently, if the trustee of such a trust is given broad administrative powers that might conceivably be used to shift assets between the income interest and the remainder interest, such powers will not be limited by the fiduciary duty to treat all beneficiaries impartially. If any restriction on such administrative powers is to be found, it can be found only in the grantor's evident intention to provide the beneficiary with a certain kind of benefit. For example, if the grantor transfers property in trust, where the income is to be paid to *A* for ten years and then the corpus is to be distributed to *A* absolutely, and if the trustee is given the discretion to allocate expenses to income and receipts to corpus, the IRS would probably argue that *A*'s income interest does not qualify for the annual exclusion because the trustee's allocation power renders the income interest unsusceptible of valuation. In order to obtain the exclusion, the grantor would have to establish that local trust law imposes such restrictions on the trustee's allocation power that the trustee would be unable to impair *A*'s income interest substantially. But what local

238. For example, suppose the trustee uses trust principal to buy 1000 shares of a mutual fund at a time when the net asset value of each share is $10. At the time of the purchase, the mutual fund has to its credit some unrealized appreciation on its common stock investments. Let us say that $2 of each share's $10 net asset value represents that unrealized appreciation. Immediately after the trust purchases the 1000 shares, the mutual fund sells its appreciated stock investments and realizes that gain of $2 per share. When the fund distributes that realized gain to its shareholders in cash, the trustee's $10,000 investment will thereupon consist of $2,000 of cash and $8,000 of mutual funds shares. If the trustee paid over that $2,000 capital gain distribution to the income beneficiary, the trustee's purchase of $10,000 of mutual fund shares immediately before the capital gain distribution would result in a diversion of $2,000 of principal to the income beneficiary.

239. *See supra* text accompanying notes 198-203.

240. *Cf.* Security Pacific Nat'l Bank v. United States, 578 F.2d 790 (9th Cir. 1978), where a claimed charitable deduction with respect to a charitable remainder trust was denied on account of the trustee's administrative powers, no evidence having been offered that local (California) law would have prevented substantial diversion of assets from the remainder.

law could be pointed to? Not the duty of impartiality, surely. Only the general proposition that a trustee is required to carry out the intentions of the grantor: in this case, the intention to provide *A* with a steady dependable flow of income from the transferred property.

Perhaps the courts in *Fischer* and *Van Den Wymelenberg* tacitly assumed that the duty to provide an income beneficiary with a steady flow of income when the beneficiary was ultimately to receive the principal was a less compelling duty than the duty of impartiality as between different beneficiaries[241] and that, consequently, any state-law limits on a trustee's discretion to allocate receipts and expenditures would be less restrictive in the case where the income beneficiary and remainderman were the same individual than in the case where they were different individuals. To be sure, there is no discussion of this theory in either of the opinions. It may be worth noting, however, that in three of the four cases favorable to the taxpayer on this issue,[242] the income beneficiaries and remaindermen were different persons. On the face of the six opinions dealing with this issue, however, there is no way to distinguish the four cases favorable to the taxpayer from the two cases unfavorable to the taxpayer.

The IRS seems to conduct itself as if the four favorable cases do not exist. In Revenue Ruling 77-358,[243] the IRS ruled that in the case of a trust whose trustee was required to allocate capital losses to corpus,[244] the income interest was not susceptible of valuation (and hence did not qualify for the annual exclusion) because the trustee could divert income away from the income beneficiary simply by choosing to sell depreciated assets. In support of its ruling, the IRS cited *Fischer* and *Van Den Wymelenberg* (the two unfavorable cases) and made no mention of any of the four favorable cases, even though in the trust being ruled upon, unlike the trusts involved in *Fischer* and *Van Den Wymelenberg*, the income beneficiary and remainderman were different persons. The ruling is also deficient in that it

241. In *Mercantile*, the trust instrument expressly provided that "the welfare of [the income] beneficiary shall be the primary concern of the Trustees." 311 F. Supp. at 675. The court relied in part on this provision to distinguish *Fischer* and *Van Den Wymelenberg*, since no equivalent provision existed in the trusts involved in those two unfavorable cases. Yet such a provision was likewise wanting in the three other favorable cases.

242. Merantile-Safe Deposit & Trust Co. v. United States, 311 F. Supp. 670 (D. Md. 1970); Martinez v. Commissioner, 67 T.C. 60 (1976); Brown v. Commissioner, 30 T.C. 831 (1958).

243. 1977-2 C.B. 342.

244. For an explanation of what it means to allocate capital losses to corpus, see *supra* note 213.

fails to consider any potential state-law restrictions on the trustee's discretion to divert income by selling depreciated assets. To quote again from the Massachusetts Supreme Judicial Court: "[S]uch a power imports no more uncertainty in the ascertainment and calculations of the value of the [income interest] than does the contingency that the precise amount of administrative charges and of [earnings] over the years cannot be known in advance."[245]

C. *Trustee's Power to Invade Corpus*

The third and last group of cases in this area are those cases where the trustee has the power to invade corpus during the existence of the income beneficiary's estate. Suppose a grantor establishes a trust whose income is to be paid to *A* for life, and whose remainder is to be distributed outright to *B* upon *A*'s death. If the trustee has the power during *A*'s life to invade corpus for *A*'s benefit—that is, to withdraw assets from the principal of the trust estate and deliver them to *A* outright—the existence of such power should not adversely affect the status of *A*'s income interest as a present interest. If assets were distributed outright to *A*, *A* would still enjoy the right to all the income from the distributed assets; his resulting absolute possession of the assets themselves would not negate his continued enjoyment of the income produced by those assets. Yet prior to 1954, courts took the position that a trustee power to invade corpus for the benefit of the income beneficiary rendered the income interest incapable of valuation and hence disqualified for the annual exclusion.[246] This position had a surface logic to it, since a life estate, as such, is extinguished if the corpus is distributed to the life beneficiary. But in substance the pre-1954 position was absurd; it meant that giving an income beneficiary an *additional* right—namely, a right potentially to enjoy the principal—turned what would otherwise have been a present interest into a future interest. Congress was justifiably unhappy with this rule and repudiated it,[247] when it enacted the Internal Revenue Code of 1954, by including the following sentence in section 2503(b):

> Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in

245. Old Colony Trust Co. v. Silliman, 352 Mass. 6, 11, 223 N.E.2d 504; 508 (1966).

246. LaFortune v. Commissioner, 263 F.2d 186 (10th Cir. 1958); Brody v. Commissioner, 19 T.C. 126 (1952); Evans v. Commissioner, 17 T.C. 206 (1951), *aff'd*, 198 F.2d 435 (3d Cir. 1952); *see* Charles v. Hassett, 43 F. Supp. 432 (D. Mass. 1942).

247. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 478, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 5122-23.

applying this subsection, if no part of such interest will at any time pass to any other person.

If the trustee has an unrestricted power to invade corpus for the benefit of someone other than *A*, it is plain that *A*'s income interest will not qualify for the annual exclusion, since the trustee could nullify *A*'s right to income by distributing the entire corpus to such other person.[248] Suppose, however, that the trustee's power to invade corpus for the benefit of that other person is subject to a restriction. Could it be argued that the income interest still qualifies for the annual exclusion because the restriction on the trustee's invasion power leaves the income interest susceptible of valuation? If the restriction takes the form of a dollar or percentage limit on the invasion power—for example, not more than $1,000 of corpus per year, or not more than one-third of the property originally transferred in trust—it seems clear that the income interest, adjusted to take account of the limited invasion power, *will* qualify for the annual exclusion.[249] But suppose the restriction takes the form of a

248. Schayk v. Commissioner, 33 T.C. 629 (1960); Riter v. Commissioner, 3 T.C. 301 (1944).

249. In Kniep v. Commissioner, 9 T.C. 943 (1947), *aff'd*, 172 F.2d 755 (8th Cir. 1949), the trustee had the discretion to distribute up to $1,000 of corpus per year to a beneficiary other than the income beneficiary; it was held that the income interest, adjusted by assuming that such $1,000 encroachments would occur each year, qualified for the annual exclusion.

The literal wording of the second sentence of § 2503(b) (added in 1954) and of the committee reports explaining such addition, *see* S. REP. No. 1622, 83d Cong., 2d Sess. 478 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5122-23, suggest, contrary to *Kniep* and the sentence to which this footnote is appended, that if *any* part of a trust's corpus may potentially be distributed to a beneficiary other than the income beneficiary during the existence of the income interest, *no* part of the income beneficiary's interest qualifies for the annual exclusion. Despite such wording, however,

> it should be held [in the case where the trustee during A's life estate may distribute up to one-half of the principal of the trust to B] under Section 2503(b), as it was under the 1939 Code [*see Kniep, supra* note 249], that A's interest qualifies for the exclusion to the extent that it cannot be diverted from A, that is, that A has a present interest in the income from one-half of the trust property which cannot be taken away from him, against which the annual exclusion may be taken. The purpose of Section 2503(b) was to repudiate the Evans case [*see supra* text accompanying notes 246-47]; to expand rather than contract the scope of the exclusion, and to make sure that the right of a beneficiary of a trust to the current income from the trust would be regarded as a present interest qualifying for the exclusion despite the existence of a power to invade the principal of the trust in the beneficiary's favor. It is difficult to believe that Congress intended that Section 2503(b) should convert an indefeasible right in part of the income from a trust into a future interest just because another part of the income beneficiary's interest might be diverted to another. The Regulations appear to adopt this view. [*See* the phrase "to the extent" in Treas. Reg. § 25.2503-3(c) Example (4) (1983).]

C. LOWNDES, *supra* note 19, § 33.9, at 822-23.

qualitative limit. For example, suppose the trustee may invade corpus for *B*'s benefit but only for *B*'s health, education, maintenance, and support. Will such a restriction on the trustee's invasion power leave *A*'s interest susceptible of valuation and hence eligible for the exclusion? In a sense, this issue is exactly the mirror image of the issue in the *Disston* case, where the question was whether an income interest was susceptible of valuation when the trustee had a discretionary power to accumulate income but the power was subject to restrictions.[250] Unfortunately, the cases dealing with discretionary powers to invade corpus are considerably less numerous than those dealing with discretionary powers to accumulate income.

In *Jones v. Commissioner,*[251] the trustee had the discretionary authority to invade corpus for the income beneficiary's "proper maintenance, education and support . . . or to provide against any emergency which [might] arise affecting" him.[252] The case arose under pre-1954 law, which provided, as we have noted, that a power to invade corpus for the benefit of the income beneficiary rendered the income interest incapable of valuation and hence ineligible for the exclusion. But the Tax Court held in *Jones* that the income interest was susceptible of valuation (and consequently qualified for the exclusion) because: "(a) the power of encroachment [was] limited by an ascertainable standard, and (b) the possibility of encroachments being made [was] so remote as to be negligible."[253] In making the second of these two determinations, the court noted that the income beneficiary had sufficient means without the trust to maintain his modest but comfortable standard of living and that the grantor intended that corpus distributions would be made to the income beneficiary only if his other sources of funds were insufficient.[254]

The *Jones* case left two important questions unanswered. First, was the same analysis to be applied in the case of an invasion power

250. *See supra* text accompanying notes 160-72.

251. 29 T.C. 200 (1957), *acq.*, 1958-2 C.B. 6.

252. The trust instrument could reasonably have been read as granting the trustee the authority to invade corpus for the benefit of the remaindermen as well as for the benefit of the income beneficiary. However, the court treated the instrument as authorizing corpus invasions only for the benefit of the income beneficiary.

253. Jones v. Commissioner, 29 T.C. 200, 212 (1957).

254. Robertson v. Commissioner, 26 T.C. 246 (1956) was another pre-1954 case dealing with a trust whose trustee had the authority to invade corpus for the benefit of the income beneficiary, where the court, for reasons essentially the same as those in *Jones*, held that the income beneficiary's interest qualified for the annual exclusion. A pre-1954 case disagreeing with *Jones* and *Robertson* was Herrmann's Estate v. Commissioner, 235 F.2d 440 (5th Cir. 1956), whose result may be explained simply by the failure of the taxpayer to meet his burden of proving, *see supra* note 25, that the possibility of encroachments on principal was small. *See* Maxfield, *Troublesome Trust Powers Under Section 2503(b)*, 47 TAXES 457, 469-70 n.48 (1969).

exercisable for the benefit of a beneficiary other than the income beneficiary? Courts have since had little difficulty answering that question in the affirmative,[255] because regardless of the identity of the beneficiary to whom corpus may be distributed, the same issue remains: namely, whether the income beneficiary's interest is rendered incapable of valuation because of the possibility that the amount of corpus whose income he is enjoying might be reduced by discretionary encroachments by the trustee. The second question left unanswered by *Jones* is whether, as long as the invasion power is limited by an ascertainable standard, the income interest may qualify for the exclusion even if the possibility of encroachments is substantial. To elaborate, we have seen in *Kniep v. Commissioner* that an income beneficiary's interest will qualify where the invasion power is limited to a fixed dollar amount per year;[256] although the possibility of encroachments in that case was not established as negligible, nonetheless the exclusion was available because the $1,000 limitation on invasion left the income interest susceptible of valuation. Might not the income beneficiary's interest similarly qualify in cases where a standard—such as the remainderman's health, education, maintenance, and support—so restricts the possibility of invasions of principal as to leave the income interest susceptible of valuation, even though the likelihood of invasion is very real? The meager gift tax authority affords no answer to this question,[257] but we may be able to find an answer in some estate tax cases.

When the *Jones* case[258] held that the income interest would not qualify for the present interest exclusion unless the likelihood of the trustee's exercising his power to invade corpus was so remote as to be negligible, it cited as authority a United States Supreme Court case dealing with charitable remainders: *Ithaca Trust Co. v. United*

255. Funkhouser's Trust v. Commissioner, 275 F.2d 245 (4th Cir.), *cert. denied*, 363 U.S. 804 (1960); Hockman v. United States, 327 F. Supp. 332 (D. Md. 1971) (involved the same trust as *Funkhouser* but for post-1954 years rather than the pre-1954 years involved in the earlier case); *see* Jolley v. United States, 259 F. Supp. 315 (D.S.C. 1966); Schayck v. Commissioner, 33 T.C. 629 (1960).

256. 9 T.C. 943 (1947), *aff'd*, 172 F.2d 755 (8th Cir. 1949); *see also* Berry v. Kuhl, 174 F.2d 565 (7th Cir. 1949).

257. It might be worth noting, however, that in Kniep v. Commissioner, 9 T.C. 943 (1947), *aff'd*, 172 F.2d 755 (8th Cir. 1949), where the trustee was authorized to distribute up to $1,000 of corpus per year to a beneficiary other than the income beneficiary but only for that other beneficiary's maintenance, support, or emergency-related expenses, the income interest was valued by assuming that the $1,000 distributions were made in full every year. Evidently it was not even argued that, because of the limitations on the trustee's distribution power, distributions of corpus would not in fact be made each year.

258. Jones v. Commissioner, 29 T.C. 200 (1957).

States.[259] That case has often been cited for the proposition that a charitable remainder under a trust whose trustee has the power to invade corpus for the noncharitable life tenant[260] will not qualify for the charitable deduction unless the restrictions on the invasion power and the life tenant's circumstances are such as to make it unlikely that the invasion power will be exercised *at all.*[261] That is, *Ithaca Trust* has been read to hold that if a decedent bequeathes property in trust—income to *A* for life, remainder to charity—and the trustee has the authority to invade corpus for *A*'s maintenance or support, the charitable deduction will be denied (on the ground that the charitable remainder is not susceptible of valuation as of the grantor's death) unless the taxpayer can prove that the income of the trust together with *A*'s other sources of wealth will be sufficient to provide for his maintenance and support and that accordingly no corpus will need to be distributed to him. Yet the *language* of the *Ithaca Trust* opinion does not require such a reading. It is true that the Court noted that the life tenant's sources of income were more than sufficient to maintain him as required; but the foundation of the Court's holding was the following observation: "The standard [that is, the rule specifying the circumstances under which the trustee was authorized to invade corpus] was fixed in fact and *capable of being stated in definite terms of money.*"[262] In the Supreme Court's next important decision dealing with charitable remainders, a decision clearly building upon the *Ithaca Trust* precedent, the Court stated that the charitable deduction would be allowed with respect to the remainder only in cases where, as a result of the specificity of the invasion standard and the foreseeability of other factors, "*the amount* which will be diverted from the charity [pursuant to the invasion power *is*] *adequately measurable.*"[263] These italicized phrases strongly suggest that the charitable deduction would be allowable (under pre-1969 law) for a charitable remainder even when the possibility of a diversion of corpus was not remote, as long as the amount of such potential diversion was susceptible of valuation.

259. 279 U.S. 151 (1929).

260. For a discussion of why a power to invade corpus for the income beneficiary will jeopardize the charitable deduction, see *supra* text accompanying notes 198-203.

261. Lincoln Rochester Trust Co. v. Commissioner, 181 F.2d 424 (2d Cir. 1950); Berry v. Kuhl, 174 F.2d 565 (7th Cir. 1949); Mercantile-Safe Deposit & Trust Co. v. United States, 252 F. Supp. 191 (D. Md. 1966); Millard v. Humphrey, 8 F. Supp. 784 (W.D.N.Y. 1934), *aff'd*, 79 F.2d 107 (2d Cir. 1935).

262. Ithaca Trust Co. v. United States, 279 U.S. 151, 154 (1929) (emphasis added).

263. Merchants Nat'l Bank of Boston v. Commissioner, 320 U.S. 256, 261 (1943) (emphasis added).

And indeed, a few courts have construed these precedents in just this way.

In *In re Estate of Judge,*[264] for example, a district court stated that the charitable deduction would be available with respect to the remainder where the possibility that the charity would not take was so remote, *at least as to a calculable portion of the corpus remainder,* as to be negligible.

> The remoteness test is utilized in order to determine the likelihood that the charity will take and the value of what it will receive. . . . Therefore, if it were factually shown that the possibility of invasion of the corpus *beyond a certain amount* was so remote as to be negligible and the value of the charitable bequest was then determinable, the remoteness test would be met and a charitable deduction allowable. If it is proven that, beyond a certain amount of the corpus the possibility of invasion of the remaining portion is so remote as to be negligible, the purpose of the remoteness test of assuring that the amount of the charitable deduction is not greater than the amount which the charity does in fact eventually receive will have been satisfied.[265]

Unfortunately, the taxpayer in *Judge* was unable to meet his burden of proving that the corpus was, beyond a certain amount, safe from incursions by the trustee. In *Salisbury v. United States,*[266] though the Second Circuit similarly indicated that the charitable deduction would be allowable if the taxpayer could prove that at least a portion of the corpus was safe from incursions, the case was remanded to the District Court to "determine the extent of possible invasion."[267] But finally, in *Estate of Schildkraut v. Commissioner,*[268] the Second Circuit not only suggested that the charitable deduction was allowable where the taxpayer could prove that at least a portion of corpus was safe from incursions, but also sustained the taxpayer's claim of a charitable deduction.[269]

264. 371 F. Supp. 716 (M.D. Pa. 1974).

265. *Id.* at 721 (emphasis added) (citation omitted).

266. 377 F.2d 700 (2d Cir. 1967).

267. *Id.* at 708.

268. 368 F.2d 40 (2d Cir.), *cert. denied,* 386 U.S. 959 (1966).

269. The *Schildkraut* case involved a rather special situation: one in which the corpus was to go either to the decedent's spouse (a potentially tax-free transfer pursuant to the marital deduction) or to a foundation (a potentially tax-free transfer pursuant to the charitable deduction). The *Schildkraut* opinion characterized this special situation as "crucial" to the decision, 368 F.2d at 49, but it is unclear what was meant. Very likely the *Schildkraut* court felt that since the decedent had evidently assumed that the transfer would, one way or another, be tax-free, and because only a technicality disqualified the transfer for the marital deduction, it would be unfair to deny him the charitable deduction merely because the corpus could be invaded for the benefit of the wife. Thus,

To the extent that these charitable remainder cases are analogous to the annual exclusion cases, and *Jones*'s citation of *Ithaca Trust* strongly implies that they are analogous, they suggest that if a power to invade corpus for the benefit of someone other than the income beneficiary is limited by an ascertainable standard, the income interest may qualify for the annual exclusion even if the possibility of encroachments is not insubstantial. But there are no annual exclusion cases so holding.

IV. Cases Involving Interests Subject to a Condition Within the Donee's Control

At first glance, this third category of annual exclusion cases may seem no different from the first category. If an income interest is subject to a condition within the donee's control, is not the interest in substance an unconditional interest? If the donee is a minor, the IRS has generally endeavored to answer this question in the negative, and virtually all the cases we shall be considering in this third category involve minor donees. But this issue can arise in the context of adult donees as well. The fundamental principle at work may be illustrated as follows. Suppose a grantor transfers property to a trust whose trustee is directed to accumulate the income for ten years and then to distribute the corpus and accumulated income to *A* and *B* in equal shares. Clearly, *A* and *B* have been given future interests. Suppose, however, that *A* is given an overriding power to terminate the trust at any time and thereupon receive the entire corpus and accumulated income. Now it should be plain that *A* has been given a present interest.[270] If, instead, *A* and *B* were given a joint power (that is, a power exercisable only by both of them, not by either acting alone) to terminate the trust and receive in equal shares the corpus and accumulated income of the trust, neither *A*

it is unclear whether *Schildkraut* holds as a general proposition that the charitable deduction is available even where the taxpayer can prove that only part of the corpus is safe from incursion, or whether it so holds only in the special situation where marital and charitable deductions are involved in the alternative. The Tax Court evidently interprets *Schildkraut* as applying only in that special situation and criticizes *Schildkraut's* analysis of that special situation. *See* Estate of Gooel v. Commissioner, 68 T.C. 504, 514 (1977), *aff'd in an unpublished opinion* (9th Cir. 1981).

270. Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); Rev. Rul. 80-261, 1980-2 C.B. 279. "If the donee receives present rights, it is not necessary to ascertain the likelihood that the rights will be exercised. . . ." Priv. Ltr. Rul. 8121051 (Feb. 26, 1981). *Cf.* Neugass's Estate v. Commissioner, 555 F.2d 322 (2d Cir. 1977), which held that when a surviving spouse was bequeathed a property interest that did not qualify for the estate tax marital deduction but was also given the power to elect to receive instead an interest that *did* qualify, the decedent was entitled to the marital deduction where the surviving spouse elected the qualifying interest.

nor *B* would have been given a present interest because neither beneficiary received an *unconditional* right immediately to possess or enjoy property; each beneficiary required the other's consent.[271]

Of course, this joint power belongs more properly in the second category of cases, since the condition that has to be met (the securing of *B*'s consent) before *A* can enjoy the property is a condition beyond *A*'s control. But consider the trust involved in Revenue Ruling 75-415.[272] A grantor had established a trust with a term of about ten years. The trustee was initially to pay the income only to *A* and *B;* but the trustee was to commence paying the income to *A, B, and C* upon the earlier of (1) the expiration of three years from the date the trust was established; or (2) the date *C* ceased to be a full-time student. In other words, *C* could immediately become entitled to receive one-third of the income, but only if he terminated his enrollment as a full-time student. Certainly, the power to quit school was a power unconditionally within *C*'s control, so it might appear from the foregoing analysis that *C* should have been deemed to receive a present interest. But the IRS ruled that *C* had received a future interest. "Although *C*'s action will result in [his immediate] enjoyment of the income interest, such action is merely a collateral consequence of a power that every student has to drop out of school. *C*'s termination of enrollment does not directly affect the trust and, therefore, is a barrier to the present enjoyment of the income interest."[273]

Although the IRS reached the correct result in this ruling, its reasoning was faulty: its talk of "collateral consequences" and "powers that do not directly affect the trust" inapposite. Suppose the trust instrument had provided instead that *C* would become immediately entitled to the income of the trust if he made his demand while wearing mismatched socks. One's instinctive reaction would be that *C* would then have received a present interest, since there would be no substantial impediment to his receiving the income immediately. Yet it could be urged in this hypothetical case, just as it was in Revenue Ruling 75-415, that *C*'s demand of the income would be merely a collateral consequence of the power that everyone has to wear

271. Ryerson v. United States, 312 U.S. 405 (1941); Skouras v. Commissioner, 188 F.2d 831 (2d Cir. 1951); Howe v. United States, 142 F.2d 310 (7th Cir.), *cert. denied,* 324 U.S. 841 (1944), *rehearing denied,* 324 U.S. 886 (1945); Ritland v. Commissioner, 51 T.C.M. (CCH) 1458 (1986); Blasdel v. Commissioner, 58 T.C. 1014 (1972), *aff'd per curiam,* 478 F.2d 226 (5th Cir. 1973); Brody v. Commissioner, 19 T.C. 126 (1952).

272. 1975-2 C.B. 374.

273. *Id.*

mismatched socks; and it could equally be urged that *C*'s wearing mismatched socks would not directly affect the trust.

The point is not that wearing mismatched socks is a power that everyone possesses; the point is not that wearing mismatched socks does not directly affect the trust;[274] the point *is* that wearing mismatched socks does not impose on the wearer any substantial onerous consequences.[275] The power to wear mismatched socks is thus a freely-exercisable power; there is no substantial barrier to *C*'s receipt of income if all he has to do to get it is wear mismatched socks. But onerous consequences *do* flow from quitting school, so that *C*'s right to the immediate receipt of income under the trust being ruled upon *was* subject to a substantial barrier. Otherwise, it might be urged that in a trust for *X* for life, remainder to *Y*, *Y* has been given a present interest since he could obtain immediate possession of the corpus by killing *X*, such acquisition being a mere collateral consequence of the power that everyone has to kill *X*.

Unfortunately, the IRS has persisted in this analytic error. Where a grantor establishes a trust during his life but reserves the power to add to the number of beneficiaries and adjust the interests among them, the trust property is included in his gross estate pursuant to section 2036(a)(2) (on the theory that he retained for life a power to designate the persons who should enjoy the transferred property)

274. The IRS likewise relies on this unhelpful notion of "not directly relating" or "not directly affecting" in its income tax regulation dealing with property transferred in connection with the performance of services. *See* Treas. Reg. § 1.83-3(c)(1) (1978).

275. The IRS used alternative language in Rev. Rul. 75-415, 1975-2 C.B. 374 to explain its ruling. The IRS stated that if a donee can obtain an immediate right to income only by performing an act, the donee's interest will be regarded as a future interest if the act is "an act of independent significance, the collateral consequences of which is [sic] commencement of income payments." This alternative wording, though it disposes of our mismatched socks example—wearing mismatched socks is plainly not an act of independent significance, so if the IRS applied this alternative language to our example rather than the language quoted in the text, the IRS would agree with our conclusion that an income interest obtainable only if the donee wears mismatched socks is a present interest—still misses the point. Suppose the donee could obtain the income interest only if he placed certain nonessential documents in his safe deposit box. Such placement has been held to be an act of independent significance. Buchwald v. Buchwald, 175 Md. 103, 199 A. 795 (1938). Yet it should be evident that no onerous consequences flow from placing nonessential documents in a safe deposit box and that, accordingly, a donee who may obtain income merely by so acting has in substance been given a present interest. Or, suppose instead that the donee could obtain the income interest only if he hired a housekeeper. It is by no means clear whether the hiring of a housekeeper is or is not an act of independent significance, *see generally* T. ATKINSON, WILLS § 81 (2d ed. 1953), but it *is* clear that onerous consequences flow from hiring a housekeeper (the consequences being, in part, the obligation to pay the housekeeper's wages); therefore, the donee's interest should be regarded as a future interest. The doctrine of acts of independent significance, evidently drawn by the IRS from the law of wills, is totally unsuited for implementing the unique policies inherent in § 2503(b).

and section 2038 (on the theory that he possessed at his death a power to alter or amend the transfer). In Revenue Ruling 80-255,[276] the IRS considered a trust for the benefit of a grantor's children. The trust instrument provided that any later-born or later-adopted children of the grantor were likewise to become beneficiaries of the trust. Although it might have been argued that the grantor's power to bear or adopt additional children was a section 2036(a)(2) power to designate new beneficiaries and a section 2038 power to alter the transfer, the IRS ruled that such a change in beneficiaries and alteration of the trust would be merely collateral consequences of the power everyone has to bear or adopt children. Again, although the IRS reached the correct result, it is submitted that the better reasoning would have been that the power to bear or adopt children, if exercised, entails substantial burdens and that, consequently, the power to bear or adopt children is not the sort of freely-exercisable power at which sections 2036(a)(2) and 2038 are directed.[277]

A. Gifts to Minors: Background

Let us turn now to the question of gifts to minors, since it is here that most of the litigation in this third category of cases arises. One very popular estate-reducing device is the making of a series of annual gifts to one's children, where each gift qualifies for the annual exclusion. By so doing, the donor transfers wealth to the persons he would, in any event, wish to benefit at his death, reduces the amount of property that will be subject to estate tax at his death, yet pays no gift tax upon the estate-reducing transfers. When the donor's children are minors, however, special considerations arise. Substantial outright gifts intended for a minor generally require that there be a guardian of the minor if the gift property is to be managed. Fortunately, the mere fact that an outright gift intended for a minor is given to the minor's legal guardian does not render the gift

276. 1980-2 C.B. 272.

277. Curiously, in the context of § 2042, which states that the proceeds of life insurance payable upon the death of a decedent will be included in his gross estate if he possessed at his death any powers over the insurance that amount to "incidents of ownership," the IRS has acknowledged that powers will not be regarded as incidents of ownership if the powers cannot be exercised "without potentially costly related consequences." Rev. Rul. 84-130, 1984-2 C.B. 194; Rev. Rul. 72-307, 1972-1 C.B. 307, 308. Yet even here, where the IRS has indeed focused on the issue of onerous consequences, it clouds its reasoning by focusing also on whether the power "directly affects" the trust. *See supra* text accompanying note 273.

a future interest.[278] Otherwise, "it would be impossible to make a gift of a present interest to a minor under guardianship, and that is not the law. . . ."[279] But a guardianship is an extremely clumsy, inflexible arrangement, and a guardian's powers under state law to administer the gift property may be insufficient to do justice to the donor's intentions.[280] A custodianship under the Uniform Transfers to Minors Act is more flexible,[281] but it requires that the donee receive the property outright when he reaches the age of 21,[282] and

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278. United States v. Baker, 236 F.2d 317 (4th Cir. 1956); Briggs v. Commissioner, 34 T.C. 1132 (1960); *see* Strekalovsky v. Delaney, 78 F. Supp. 556 (D. Mass. 1948); Rev. Rul. 59-78, 1959-1 C.B. 690.

> In the case of an outright and unrestricted gift to a minor, the mere existence or nonexistence of a legal guardianship does not of itself raise the question whether the gift is of a future interest. . . . It is only where delivery of the property to the guardian of a minor is accompanied by limitations upon the present use and enjoyment of the property by the donee, by way of a trust or otherwise, that the question of a future interest arises.

Rev. Rul. 54-400, 1954-2 C.B. 319.

In Messing v. Commissioner, 48 T.C. 502 (1967), the donor made gifts consisting of instruments drawn in the names of "*A* in trust for *B*," where *B* was a minor and *A* was *B*'s parent. These instruments were deposited in a bank account likewise designated "*A* in trust for *B*." "Petitioner testifies that he intended that [*B*] have the immediate benefit of the gifts; that the funds be used for [*B*'s] support and maintenance and exclusively for [*B*'s] benefit. . . . We find his testimony wholly credible." *Id.* at 513. Accordingly, the court held *B*'s interest to be a present interest. *But see* Newmaker v. Commisisoner, 12 T.C.M. (CCH) 232 (1953); Downey v. Commissioner, 11 T.C.M. (CCH) 203 (1952), where similar informal "in trust for" arrangements were held, because of the donor's apparent intentions, to be future interests.

279. Briggs v. Commissioner, 34 T.C. 1132, 1136 (1960).

280. *See* Fratcher, *Powers and Duties of Guardians of Property*, 45 IOWA L. REV. 264 (1960); *see also* 1 A. SCOTT, *supra* note 75, at § 7.

281. A custodian differs from a guardian in that a guardian's authority is conferred by courts pursuant to state law, while a custodian is invested with authority by the donor; and a custodian's discretion under the Uniform Transfers to Minors Act to withhold the property from the donee until he reaches age twenty-one is often considerably broader than that of a guardian. *See* UNIF. TRANSFERS TO MINORS ACT § 14(a)-(b) (1983). Ordinarily, such a power to come between the donee and his enjoyment of the property renders the gift a future interest. *See, e.g.,* Commissioner v. Disston, 325 U.S. 442 (1945); Hutchings-Sealy Nat'l Bank v. Commissioner, 141 F.2d 422 (5th Cir. 1944). As it happens, the powers that the special rule of § 2503(c) allows to be interposed between the minor donee and the gift property are precisely the powers that a custodian under the Uniform Act possesses. *See supra* note 12. One of the effects of Congress's enactment of § 2503(c) was thus to qualify gifts to minors under the Uniform Act for the annual exclusion. Rev. Rul. 73-287, 1973-2 C.B. 321; Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-86, 1956-1 C.B. 449.

282. UNIF. TRANSFERS TO MINORS ACT § 20(1) (1983). The IRS has ruled that gifts made pursuant to the Uniform Act qualify for the annual exclusion pursuant to I.R.C. § 2503(c). Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-86, 1956-1 C.B. 449. At the time of the 1959 ruling, the statute was known as the Uniform Gifts to Minors Act ("UGMA"); it is now known as the Uniform Transfers to Minors Act ("UTMA"). Although the powers conferred on a custodian under UTMA are considerably broader

the donor might not have confidence in his child's ability, at such a young age, to manage and control all the property that the donor has transferred to the custodian over the years.

The trust clearly commends itself as the method of choice for such a donor. But the trust must be established in such a way as to give the child a present interest in each of the donor's contributions to the trust. The donor might avail himself of the section 2503(c) exception[283] and establish a trust along the lines required by that provision; but again, in order to come within that exception, a trust must provide that the entire property be distributed outright to the beneficiary when he reaches 21. Suppose the donor wants to keep the donee from obtaining full control over the property until the donee reaches the age of 30. If the donor transferred property in trust, where the trustee was required to distribute all the income to the donee until he reached 30 and then to distribute the corpus to him, the transfer would qualify for the annual exclusion but would be subject to two disadvantages. First, the donor might not wish to require the trustee to distribute all the income to the donee, particularly if the donee was a very young child.[284] Second, since the do-

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than those conferred by UGMA—*compare* UNIF. TRANSFERS TO MINORS ACT §§ 12-14 (1983) *with* UNIF. GIFTS TO MINORS ACT § 4 (1966)—the IRS's position announced in the 1959 ruling should be unaffected by such changes. Note that were it not for § 2503(c), a gift to a custodian under the Uniform Act would not qualify for the annual exclusion. *See supra* note 12.

283. *See supra* note 12.

284. If a trust instrument requires the trustee to distribute all income currently to the beneficiary, the grantor will be entitled to an exclusion even if the beneficiary is a minor. But although the *tax* law does not require the grantor to make special provision when the beneficiary is a minor, state trust and property law does. After all, what would a three-year-old child do with a check presented to him by a trustee? As a practical matter, someone must receive that income on behalf of the minor and apply it for the minor's benefit. Thus, a grantor who wishes to give a minor an income interest under a trust will be obligated not by tax law but by property law (and by the realities of trust administration) to make special provision as to how the distributions are in fact to be made. And these special provisions need to be carefully drawn so as not to constitute a barrier to the minor's present enjoyment of the income.

In the 1940's and 1950's, a number of drafters had the seemingly sound idea of authorizing the trustee to expend income for the minor beneficiary's benefit "as if the interest of the minor in the trust property were held by the trustee as guardian for said minor." Some cases held that such language created a present interest, United States v. Baker, 236 F.2d 317 (4th Cir. 1956); Strekalovsky v. Delaney, 78 F. Supp. 556 (D. Mass. 1948), while other cases, involving absolutely indistinguishable trust provisions, held that such language created a future interest, Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952); Katz v. Commissioner, 27 T.C. 783 (1957); *see* Gother v. Commissioner, 28 T.C. 542 (1957). In Rev. Rul. 59-78, 1959-1 C.B. 690, the IRS attempted—unpersuasively, in my opinion—to distinguish cases like *Baker* from cases like *Stifel*. The IRS announced that if the trust instrument *required* the trustee to apply the trust property as if he were the beneficiary's guardian, the beneficiary's interest would be a present interest (regardless of the nature of any restrictions imposed on guardians' powers by nee's present interest under such a trust would consist only of an income right, the donor would have to transfer a greater amount of property in trust in order to enjoy the full $10,000 exclusion. For example, suppose the donee was 14 years old when the trust was established. If the donor transferred $10,000 to such a trust (income to donee until age 30, then corpus to donee), the value of the donee's present interest (a right to income for sixteen years) would be only $7,824. In order to receive the full $10,000 exclusion, the donor would have to transfer $12,782 to the trust.[285]

The arrangement of choice for such a donor is the trust that has come to be known as the *Crummey* trust. The donor establishes a trust for a minor child; the trustee may or may not be authorized to make discretionary distributions to the child during the term of the trust; the trust is to terminate when the child reaches the age of, say, 30, at which time the corpus and accumulated income are to be distributed to him. If, during the first year of such a trust's existence (Year 1), the donor transferred $10,000 to the trust, that would ordinarily constitute the gift of a future interest. But, in addition to the trust terms just noted, a *Crummey* trust provides that each year during which a contribution to the trust is made, the child has an overriding power to demand that the trustee distribute to him that year's contribution. The demand power is noncumulative, so that if the child does not exercise his power during Year 1 and if another $10,000 is contributed to the trust in Year 2, the child may demand the distribution of only that second year's $10,000; the power to demand the contribution for Year 1 lapses at the end of Year 1. The donor's hope is that each year's $10,000 contribution will be re-

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applicable local law); but if the trust instrument merely gave the trustee the *discretion* to apply the trust property as if he were the beneficiary's guardian, the interest would be a future interest. One court's decision would moot the revenue ruling, since it holds that even a mere discretionary authority to apply the property as if the trustee were the beneficiary's guardian will qualify the gift for the exclusion pursuant to § 2503(c), at least where the trust instrument requires the outright distribution of the trust property to the beneficiary at age twenty-one. Ross v. United States, 348 F.2d 577 (5th Cir. 1965). But if the grantor merely enumerates in the trust instrument the alternative methods that the trustee may employ in administering the property for a minor's benefit and does not use the particular form of words "as if he were guardian," the interest might be regarded as a future interest even if the enumerated powers are no different from those conferred on a guardian by applicable local law. Benton v. Commissioner, 27 T.C.M. (CCH) (1968).

It is tempting to condemn this line of cases as simply elevating form over substance. But such criticism would imply that the courts have at least adhered to *form* in a consistent manner, and they have not done even that. The results reached in these cases appear altogether whimsical; there is simply no way to distinguish these contrary cases from each other.

285. *See* Treas. Reg. § 25.2512-5(c) (1984).

garded as the gift of a present interest because the donee has an immediate right to demand that $10,000.[286] The donor's expectation, however, is that the demand power will never in fact be exercised, since the donee is a minor child. Note that the *Crummey* trust gives the donor exactly what he wants. It allows him an annual exclusion for gifts to his minor children yet, as a practical matter, debars those children from immediately enjoying the gifts.[287]

I have described the background of *Crummey* trusts in such detail to explain why the IRS was so anxious to put a stop to them. The donor of a *Crummey* trust bases his claim to an annual exclusion on the existence of a demand power that he fully intends and expects will never be exercised. But although the IRS is justified in its opposition to *Crummey* trusts, there is no logical basis, given the existing case law, for denying an exclusion for contributions to *Crummey* trusts, as the IRS has finally, albeit reluctantly, conceded. However, the change in the definition of future interest to be proposed later in this article would solve the IRS's problem.

B. *The Effect of a Beneficiary's Minority Upon His Power to Demand Distributions*

The issue in this line of cases is a simple one: if a trust beneficary has the power to demand trust corpus, a power that ordinarily gives its possessor a present interest, will the beneficiary's interest still be a present interest if the beneficiary is a minor and therefore unlikely to exercise the power? For a number of years, the principal authority on this point consisted of two contradictory and irreconcilable

286. *See supra* note 270, *Crummey* trusts raise some other important tax issues unrelated to the annual exclusion. For an excellent, comprehensive discussion of these other issues, see Natbony, *The Crummey Trust and "Five and Five" Power After TEFRA*, 60 TAXES 497 (1982).

287. *Crummey* trusts enjoy another advantage over § 2503(c) trusts. In order for a trust to qualify for the exclusion pursuant to § 2503(c), the trustee's authority to expend income for the beneficiary's benefit during his minority must be essentially unrestricted. Treas. Reg. § 25.2503-4(b)(1) (1958). Consequently, the grantor of such a trust would be unwise to appoint himself trustee, since, should he die during the term of the trust, the trust property would be included in his gross estate for federal estate tax purposes. *See* Lober v. United States, 346 U.S. 335 (1953). But in the case of a *Crummey* trust, since the annual exclusion depends on the existence of the donee's demand power rather than on the nature of the trustee's discretionary authority, restrictions on the trustee's discretion to make distributions will not jeopardize the exclusion. Consequently, the grantor of a *Crummey* trust may appoint himself trustee and yet escape estate tax should he die during the term of the trust, as long as he limits the trustee's (that is, his own) discretionary distribution powers by a fixed, ascertainable standard. *See* Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

cases: *Kieckhefer v. Commissioner*[288] and *Stifel v. Commissioner.*[289] *Kieckhefer* applied an objective test that had at least the virtue of simplicity. It held that the determination whether a donee has received a present interest turns solely on whether the terms of the trust instrument purport to create an unrestricted demand power in the donee, not on whether the donee can, as a practical matter, exercise the demand power. In deciding whether a demand power amounts to a present interest, courts should, it held, consider only restrictions on the exercise of the power that are imposed by the donor, not restrictions arising from legal disability. Although, at the time of the gift in *Kieckhefer,* the donee was a minor and no guardian had been appointed, nonetheless a guardian *could* have been appointed, and such a guardian could have exercised the demand power under the terms of the trust. Consequently, the court upheld the grantor's claim of an exclusion.[290] It is the right to enjoy, said the court, and

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288. 189 F.2d 118 (7th Cir. 1951).

289. 197 F.2d 107 (2d Cir. 1952).

290. *Kieckhefer* was followed in a number of cases: *e.g.,* United States v. Baker, 236 F.2d 317 (4th Cir. 1956); Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); Welles v. Sauber, 142 F. Supp. 449 (N.D. Ill. 1956). In Trust No. 3 v. Commissioner, 285 F.2d 102 (7th Cir. 1960) (the same court that decided *Kieckhefer*), a case arising under the income tax laws, the IRS advanced an argument similar to its argument in *Kieckhefer.* The grantor had established a trust for the benefit of three minors, each of whom was granted the overriding power to terminate the trust as to his one-third share and receive that share outright. Section 678 provides that if an individual other than the grantor possesses the power to demand the corpus of a trust, that individual, rather than the trust itself, will be required to pay income tax on the trust's income, whether or not the power is in fact exercised. Accordingly, one would think that each beneficiary would be taxed on one-third of the income. But the IRS argued that no person was qualified to make the demand—because the beneficiaries were minors and no guardians had ever been appointed for them—and that the trust income should therefore be taxed to the trust. The court rejected the IRS's argument and applied § 678 to tax each of the beneficiaries.

> It is not denied by [the Commissioner] that the beneficiaries were given a right to terminate the trust and to take possession of the trust property, but he considers that their minority bars them because (he says) they could not assert that right except through a guardian duly appointed. This distinction is unconvincing in view of the fact that the appointment of a guardian for a minor under a state law is a matter of routine in which the federal government has no concern. To effectuate a termination of the trust as to any child and a delivery of its share of the accumulated income or corpus to the child, customarily there would be delivered to the trustees a properly authenticated copy of letters of guardianship and a receipt for the assets and monies delivered. However, we think the necessity of such routine steps would have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate trust. We should not deny an undisputed right because the conventional methods of exercising it have not been desribed in the instrument creating the right.

Trust No. 3, 285 F.2d at 106.

not actual enjoyment that is the basis for a determination that the gift is of a present interest.

The objective test applied by *Kieckhefer* has the virtues of simplicity and predictability to recommend it, and a contrary result would "[reduce] to a myth [the IRS's] concession that 'gifts to minor beneficiaries are placed on an equality with gifts to adults.' "[291] If, the court in *Kieckhefer* urged, a donor simply deposited money in a bank account in the name of a minor, such a gift would be, by the IRS's own concession,[292] the gift of a present interest. Is not a minor's capacity to exercise a demand power under a trust no less substantial than his capacity to withdraw money from a bank? Are not both powers fundamentally the same kind of power? By the IRS's argument, because a child's guardian or parent will always exercise control of some sort over the disposition of the child's property, only if the child's rights were those of "a boy to his top" or a "girl to her doll" would the gift qualify.[293] Since, stated the court, the IRS has never taken that position with respect to gifts to minors—indeed, has repudiated that position—its position in this case is unsound.

It is difficult to fault the logic of the *Kieckhefer* case and its cogent confutation of the IRS's position. Yet, this logical approach permits an annual exclusion to be awarded for an arrangement that "emits a . . . strong odor of sham."[294] The donee in *Kieckhefer* was less than a month old at the time of the gift. Can it seriously be supposed that the donor in that case intended, by his grant of the overriding demand power, to give the donee immediate possession and enjoyment of the property?

The *Stifel* court, perhaps with that odor of sham in its nostrils, reached a result contrary to *Kieckhefer*. *Stifel* held that the exclusion should be denied unless at the time of the gift a guardian has already been appointed for the minor beneficiary, a guardian authorized to exercise the demand power on behalf of the minor.[295] In so

291. *Kieckhefer*, 189 F.2d at 121.

292. Rev. Rul. 54-400, 1954-2 C.B. 319.

293. This representation of the *Kieckhefer* analysis is taken from a case that disagreed with it, Stifel v. Commissioner, 197 F.2d 107, 110 (2d Cir. 1952), but *Stifel*'s representation is nonetheless accurate.

294. Peschel, *Major Recent Tax Development in Estate Planning*, 33 U. So. CAL. TAX INST. 1401.1 (1981). Professor Peschel's characterization applied to all *Crummey* trusts, not merely to the trust at issue in the *Kieckhefer* case.

295. A case following the *Stifel* view was Perkins v. Commissioner, 27 T.C. 601 (1956), *acq.*, 1965-2 C.B. 6, where the trust instrument provided that the beneficiary's demand power could be exercised, while he was a minor, by his parent or duly appointed guardian. The court conceded that if the exercise of the demand power had been limited to the beneficiary himself or to his guardian, the IRS's argument that he received a future interest "might well be tenable" if no guardian had been appointed at the time

holding, the *Stifel* court expressed concern with whether the donee's right to possession or enjoyment of the transferred property was *in substance* an immediate one,[296] rather than with whether the donee had *on paper* an immediate right to possession or enjoyment. Such concern is, to be sure, unexceptionable, but the *Stifel* court found no sound way of repudiating the *Kieckhefer* case or faulting the logic of its criticism of the IRS's position. All the *Stifel* court could muster was a flippant dismissal: "We believe [the *Kieckhefer*] view under-estimates the traditional judicial knack of line-drawing."[297] But the logical difficulty cannot be so easily brushed aside.

In 1968, *Crummey v. Commissioner*[298] adopted a position somewhere between *Kieckhefer* and *Stifel,* though it is doubtful that the authors of *Crummey* thought of themselves as reconciling the two earlier cases. On the one hand, *Crummey* rejected the *Stifel* doctrine that a minor beneficiary's demand power could give rise to the annual exclusion only if there was in fact a guardian appointed for him at the time of the gift. On the other hand, *Crummey,* though sympathetic to *Kieckhefer,* nonetheless rejected the *Kieckhefer* approach of looking only to the terms of the trust instrument and ignoring the donee's circumstances.

Crummey held that the availability of the exclusion turned on whether the donee was capable of immediately enjoying the property—that is, whether he was capable of making the demand. The court concluded that under California law the minors *were* capable of making such a demand,[299] even though they were not capable of instituting a lawsuit.

> We cannot agree with the position of the Commissioner because we do not feel that a lawsuit . . . is a necessary prelude to the making of a demand upon the trustee. As we visualize the hypothetical situation, the child would inform the trustee that he demanded his share. . . . The trustee would [then] petition the court for the appointment of a legal guardian and then turn the funds over to the guardian. . . . The only time when the disability to sue would come into play, would be if the

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of the gift. *Id.* at 605. But since the demand power could also be exercised by the beneficiary's parent, and since the parent was not incompetent to exercise the power, the beneficiary's interest was held to be a present interest.

296. Indeed, the *Stifel* court went so far as to hint that even if a guardian *were* already appointed at the time of the gift, the exclusion would be denied if such guardian was unlikely to exercise the demand power.

297. 197 F.2d at 110.

298. 397 F.2d 82 (9th Cir. 1968).

299. The court noted that under California law, a minor may own property, receive a gift, and make demand for his own funds from a bank, savings institution, or corporation. *Id.* at 86.

> trustee disregarded the demand and committed [thereby] a breach of trust. That would not, however, vitiate the demand.[300]

In other words, the appointment of a guardian is not necessary in order for the beneficiary to demand the property, merely for the beneficiary to receive the property; and it is the demand and not the receipt that entitles the beneficiary to the enjoyment of the property.

How far may the *Crummey* result be extended? The youngest of the beneficiaries in *Crummey* was eleven years old, an age when a child might be expected to comprehend the meaning and nature of his power to demand property under the trust. Would the *Crummey* court have upheld the exclusion in the case of a one-year-old beneficiary? The *Crummey* opinion goes rather far. It holds that the exclusion is available even if the beneficiary does not know that he has the right to demand funds from the trust and even if the demand right arises so shortly before its expiration that the time within which the beneficiary might exercise it is severely limited. From the point of view of the taxpayer intent upon establishing a trust with that "odor of sham"—that is, a trust for minors that qualifies for the exclusion even though as a practical matter the beneficiaries will not be able to enjoy the property immediately and even though section 2503(c) is not complied with—*Crummey* seems almost too good to be true.

The IRS, after the defeats it sustained in *Kieckhefer, Gilmore v. Commissioner,*[301] and *Crummey,* became reconciled to allowing the exclusion in cases of minors' demand powers. In 1973, it announced its acquiescence in *Crummey* in instances where there was no impediment under the trust instrument or local law to the appointment of a guardian.[302] Indeed, the IRS's concession seemed to extend to cases where the beneficiary was only a new-born baby, for the IRS admitted in the ruling that "it is not the actual use, possession, or enjoyment by the donee which marks the dividing line between a present and a future interest, but rather the right conferred upon the donee by the trust instrument to such use, possession, or enjoyment."

300. *Id.* at 87.
301. 213 F.2d 520 (6th Cir. 1954).
302. Rev. Rul.73-405, 1973-2 C.B. 321.

C. *The Effect of a Beneficiary's Lack of Notice or Opportunity Upon His Power to Demand Distributions*

Eventually, the IRS became concerned about the issues of notice and opportunity that *Crummey* had brushed aside so cavalierly. This concern was first expressed in a private letter ruling[303] and was finally put in binding form in Revenue Ruling 81-7.[304] In each of these rulings, the trust beneficiaries who were given a power to demand trust distributions—specifically, a power, upon initial funding or any subsequent additions to the trust, to demand the lesser of the amount transferred to the trust or $3,000—were competent adults. Yet, in each case the donor was denied an annual exclusion for contributions to the trust because the beneficiaries were not notified of the existence of their demand power and were not afforded an adequate opportunity to exercise it. In each case, the donor made the contribution to the trust on December 29, and the demand power lapsed if not exercised by December 31.

In *Crummey*, it will be recalled, the exclusion was allowed even where the beneficiaries did not know of their demand right and even where their right arose so shortly before its expiration as to be practically unexerciseable. But *Crummey* involved minor beneficiaries, so the IRS in Private Letter Ruling 7946007 sought to distinguish *Crummey*—without mentioning *Crummey* by name—in a rather curious way. In the case of each of the adult beneficiaries described in the letter ruling, his lack of knowledge of his demand power was the result of the acts and decisions of the donor:

> The [beneficiary's] right of enjoyment was not absolute, but rather was dependent upon the contingency that he learn of his demand right before the end of the year. The donor, by not informing the beneficiary of his demand right, was responsible for the loss of this right. The enjoyment by the donee was lost due to the will of another person, that of the donor.[305]

303. Priv. Ltr. Rul. 7946007 (July 26, 1979).

304. 1981-1 C.B. 474. A private letter ruling, unlike a revenue ruling, is not binding upon the IRS as precedent and may not be relied upon by any taxpayer other than the taxpayer who requested and received it. Minchin v. Commissioner, 335 F.2d 30 (2d Cir. 1964); Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959); Bornstein v. United States, 345 F.2d 558 (Ct. Cl. 1965). However, courts may (and do) use such private letter rulings as an aid to interpretation in matters concerning other taxpayers. Hanover Bank v. Commissioner, 369 U.S. 672, 686-87 (1962).

305. This reference to "the will of another person" recalls to mind the general proposition that if a donee's enjoyment of transferred proeprty is subject to the will or consent of another, the donee's interest is a future interest. *See supra* text accompanying note 149.

This curious distinction was reiterated in Revenue Ruling 81-7: "[T]he donor's conduct makes the demand right illusory and effectively deprives [the beneficiary] of the power." On the other hand, said the IRS in the letter ruling, when the beneficiary is a minor or incompetent, the beneficiary's lack of knowledge of the demand power is the result not of the donor's actions but rather of the beneficiary's condition.

This suggestion that *Crummey* will not be followed where the beneficiary's lack of knowledge is attributable to "the will of another person" is troublesome, to say the least. Suppose the donor chooses to notify the beneficiary by mail of his right to demand trust property, and the postal service fails to deliver the letter. Is the exclusion to be denied? Should it matter if the donor *knows* that there have been mail delivery problems in the beneficiary's neighborhood? Should it matter if the failure to deliver the letter was the result of a deliberate act of a letter carrier who hated the beneficiary rather than mere negligence on the part of the postal service? Is it sound to hold that if the beneficiary is 17 years and 364 days old the donor need not notify him of the existence of the power, yet if the beneficiary is 18 years and 1 day old the donor must notify him? And what about the denial to the beneficiary of an adequate time within which to exercise the power? If the beneficiary is allowed only 3 days within which to exercise the power, a period that the IRS considers so short as to render the power worthless,[306] is not such "worthlessness" attributable to the donor's acts whether the beneficiary is a minor or an adult? Yet the language of Private Letter Ruling 7946007, though ambiguous, is at least susceptible of the construction that in the case of a minor beneficiary the exclusion will be allowable even if the power may be exercised only within a short period after its creation. In subsequent favorable rulings involving minor beneficiaries, the IRS avoided all of the problems adverted to earlier in this paragraph by confining its discussion to trusts whose trustees were required to notify the beneficiaries of the existence of the demand power and whose beneficiaries were thereupon afforded a reasonable period of time within which to exercise the power.[307]

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306. Rev. Rul. 81-7, 1981-1 C.B. 474; Priv. Ltr. Rul. 7946007 (July 26, 1979).

307. Rev. Rul. 83-108, 1983-2 C.B. 168; Priv. Ltr. Rul. 8335050 (May 27, 1983); Priv. Ltr. Rul. 8121051 (Feb. 26, 1981); Priv. Ltr. Rul. 8004172 (Nov. 5, 1979). In these four favorable rulings, the shortest of the periods within which the minor beneficiary was required by the trust instrument to exercise the demand power or suffer it to lapse was 30 days. Priv. Ltr. Rul. 8004172 (Nov. 5, 1979).

Even if a trust beneficiary has a power to demand trust corpus, if the trustee has an independent power to invade corpus for the benefit of a second beneficiary, the first

One can appreciate the IRS's desire to sniff out that "odor of sham" and to deny the exclusion in cases where in substance no present interest was conferred. But the distinctions on which the IRS is relying to prevent abuse of section 2503(b) seem specious and unsatisfying. It is the *right* to demand, not the actual demand itself, that renders the donee's interest under a *Crummey* trust a present interest. If a donor transfers property in trust on December 29, 1983, and informs the beneficiary on that date that the beneficiary has the power, if exercised within, say, forty-five days, to demand the contributed property, the donor may claim the annual exclusion on his 1983 gift tax return even if the donee does not exercise the demand power until 1984 (and even if he never exercises it). Indeed, the IRS ruled in Revenue Ruling 83-108[308] that the donor would be entitled to claim the exclusion on his 1983 return even if the donee did not receive notice of the forty-five day demand power until 1984, as long as the trust instrument required the trustee to notify the beneficiary promptly of the existence of the power and of the contribution subject to the power. This concession by the IRS is puzzling, because a donee's right to be notified within forty-five days or even three days of the power's creation is not an *immediate* right to be notified. (It will be recalled that postponements even of very short duration have been held to transform what would otherwise have been present interests into future interests.)[309] Perhaps the IRS was applying a "good faith" standard in Revenue Ruling 83-

beneficiary's demand power does not accord him a present interest, because by the time the beneficiary exercised his demand power the trustee might already have invaded the corpus for the benefit of the other. Priv. Ltr. Rul. 8213074 (Dec. 30, 1981). Perhaps for this reason, the trust in Priv. Ltr. Rul. 8121050 provided that during the sixty-day period within which the beneficiaries had to exercise the demand power or suffer it to lapse, the trustee was precluded from making any invasions of corpus unless all the beneficiaries had waived their withdrawal privileges. In drafting a *Crummey* trust for multiple beneficiaries, the drafter would do well to include in the trust instrument such a suspension of the trustee's invasion power.

308. 1983-2 C.B. 168.

309. *See supra* text accompanying notes 39-43. The IRS seems to have recognized the inconsistency between the position it took in Rev. Rul. 83-108, 1983-2 C.B. 168, and the position it took in the cases involving short postponements of enjoyment, *see* cases discussed *supra* at text accompanying notes 39-43, for near the end of the revenue ruling, the IRS said:

> The holding in this ruling does not reflect a change in the Service's position that, if a trustee has discretion upon creation of the trust to accumulate the trust income for even a brief period, the income interest is a future interest. See *Hessenbruch v. Commissioner*, 178 F.2d 785 (3d Cir. 1950), *see also Estate of Jardell v. Commissioner*, 24 T.C. 652 (1955).

Rev. Rul. 83-108, 1983-2 C.B. 168. But such language amounts to a mere disclaimer and offers no argument for distinguishing the *Hessenbruch* and *Jardell* cases from the 1983 ruling.

108, the thought being that if the donor directs the trustee to notify the beneficiary promptly after the beneficiary's demand power is conferred, such a direction demonstrates that the donor intended to confer a bona fide exercisable demand power rather than the kind of sham power that the IRS fought unsuccessfully in *Kieckhefer*. But although a good faith test may be a sound way of distinguishing transactions with the odor of sham, is it a good way of determining whether a donee has been given an immediate right?

V. Proposal for Change

There is no doubt that the case law and rulings defining "future interest" for gift tax purposes present an unsatisfactory record. Cases and rulings often contradict each other and fail to give the kind of guidance that planners can comfortably and prudently rely on. Much of the confusion in this area can be traced to the now-unassailable rule that an income interest under a trust is a present interest if the right to payments is immediate and unconditional. This rule cannot but produce the most bothersome anomalies. If a grantor transfers $10,000 in trust, where the income is to be paid to *A* for ten years and the remainder is then to be paid to *A* outright, the grantor gives *A* a larger present interest for gift tax purposes than if the income was to be paid to *A* for only five years and then remainder to *A*;[310] yet the first trust (which involves the larger present interest) postpones *A*'s enjoyment of the underlying property for a longer period than does the second trust. Someone unencumbered by a knowledge of the case law would assume that *A*'s interest under the five-year trust was more of a present interest than his interest under the ten-year trust.

Judge Wyzanski called attention to these anomalies quite early in the annual exclusion's history. In *Charles v. Hassett*,[311] a donor transferred $5,000 in trust, the income to be paid to *A* for life and the

310. If a grantor transfers property in trust, where the income is to be paid to *A* for a term and then the underlying property is to be distributed outright to *A* at the expiration of the term, only the term income interest is a present interest qualifying for the annual exclusion. Thus, where the corpus is worth $10,000 at transfer, *A*'s present interest under the 10-year trust would be worth $6,145, whereas *A*'s present interest under the 5-year trust would be worth only $3,791. Treas. Reg. § 25.2512-5 (1984).

This rule gives rise to another anomaly. We saw earlier that if a grantor transfers property in trust where the income is to be paid to *A* for life, but the trustee has the power to invade corpus for *A*'s benefit, *A* is regarded as having received a present interest consisting of the full life income interest. § 2503(b) (second sentence); *see supra* text accompanying notes 246-47. Yet if instead the trustee is *required* to distribute the entire corpus to *A* after, say, five years, *A*'s present interest will consist of only the five-year income interest.

311. 43 F. Supp. 432 (D. Mass. 1942).

principal to be paid to *A* one-third at age 25, one-third at age 30, and one-third at age 35. (There was a gift over to other persons if *A* died before full distribution was made to him.) Although Judge Wyzanski felt compelled by such case law as then existed to hold that the gift of the income was a present interest[312] while the gifts of principal were future interests, he was troubled by the result.

> [T]here is no practical difference between payments of income to a donee if living and payments of corpus to a donee if living: each type of payment is to be made in the future; each depends upon the survivorship of the donee and each can be appraised by an actuary familiar with interest and discount tables and with mortality tables. . . . [S]ince these interests are for practical purposes alike, since these interests have a present value, since the donor has retained nothing, and since the interests are vested in the same person, [it might reasonably be argued that] they should be treated together as a "present interest" under the gift tax law. [It might, with equal persuasiveness, be argued in the alternative,] starting from the same premises, but putting more emphasis on the uncertainty and especially the remoteness in time, which underlie the payments of both income and of corpus, [that] both interests [are] "future interests" and hence not excludable. . . .[313]

Furthermore, Judge Wyzanski believed that this difference in treatment between income and corpus might be at variance with Congress's purpose in limiting the annual exclusion to gifts of present interests:

> Congress, though it did not speak clearly, may have meant to exclude from the gift tax only those gifts which the donee re-

312. Although his opinion is not altogether clear on this point, it appears that Judge Wyzanski regarded the present interest as consisting of: (1) the income from one-third of the $5,000 corpus from the date of settlement to the earlier of *A*'s death or age 25; (2) the income from one-third of the $5,000 corpus from the date of settlement to the earlier of *A*'s death or age 30; and (3) the income from one-third of the $5,000 corpus from the date of settlement to the earlier of *A*'s death or age 35. *See supra* note 310.

313. *Charles*, 43 F. Supp. at 434.

Reconsider at this point Rev. Rul. 75-506, 1975-2 C.B. 375, discussed *supra* at note 69. Each beneficiary therein was held to have received a present interest only of the income from his one-half share; his survivorship interest in the income from the other one-half share was held to be a future interest because it did not commence until a future event: the death of the other beneficiary. Now it is true that a beneficiary's income payments from the other share would not begin until the future and then would begin only if he survived the other beneficiary. But is it not equally true that income payments from his own share of the trust were to be paid only in the future and were contingent on his surviving to the date of accrual? Since the likelihood of one beneficiary's surviving the other may be predicted actuarially with no less certainty than the life expectancy of either beneficiary, is it logically sound to treat each beneficiary's two income interests differently?

> ceived and was free to dispose of during the taxable year. This would allow for the customary anniversary, holiday and like gifts without making it possible for the donor to escape taxation on the equivalent of a testamentary trust. Moreover, it is startling to a layman to be told that for tax purposes he has a "present interest" when all the gift is to be paid in the future and is to be paid only if he lives.[314]

With Judge Wyzanski's comments in mind, I would urge that the definition of "future interest" be changed so that a gift will not qualify for the annual exclusion unless the donee receives at the instant of the gift the entire legal and equitable title to the gift property: "fee simple absolute" in the case of real property and "absolute ownership" in the case of personal property.[315] (This proposal will hereinafter be referred to simply as "the proposal.") A mere power to demand property, a power distinct from the ownership interest, would not qualify as a present interest. Thus, a contribution to a *Crummey* trust[316] would not qualify. Consequently, the proposal would bar transactions with that "odor of sham" discussed above[317] and obviate the necessity of drawing the unwarranted distinctions that the IRS has attempted to draw.[318]

In a sense, the proposal might be regarded as a throwback to such law as existed from 1938 to 1942, when Congress barred the annual exclusion for gifts in trust.[319] The proposal goes further, however, in that it would also bar the annual exclusion for such nontrust gifts as legal life estates and determinable fees. This expansion of old law is justified because Congress's short-lived rule regarding trusts was a response to a particular line of cases, whereas the proposal is an attempt to return to the very foundation of the annual exclusion and its confinement to present interests. As Judge Wyzanski reminds us in the *Charles* opinion, the purpose of denying the exclusion for gifts of future interests is to limit the exclusion to the routine gifts that a donor makes for ordinary donative reasons and to bar the exclusion for gifts made for estate planning motives.[320] Gifts whereby the donee receives something less than full legal and

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314. *Charles*, 43 F. Supp. at 434.

315. This recommendation is not wholly novel. Judge Wyzanski's opinion in the *Charles* case points strongly in this direction. And a similar recommendation was made, though in an extremely offhand way, in Maxfield, *Troublesome Trust Powers Under § 2503(b)*, 47 TAXES 457, 484 (1969). The need for adoption of this recommendation has, if anything, increased since the 1969 article was written.

316. *See supra* text accompanying notes 286-309.

317. *See supra* text accompanying note 294.

318. *See supra* text accompanying notes 304-09.

319. *See supra* note 5.

320. *See supra* text accompanying notes 19-23.

equitable title are almost invariably made only with the advice and intervention of an attorney or other professional with a knowledge of tax law. Such gifts cannot be regarded as the kind of routine gifts Congress sought to exclude from the transfer tax base. Thus, income interests under trusts would no longer qualify for the annual exclusion under the proposal, even if the income was to begin immediately and the right to it was unconditional. It must be admitted in the case of determinable fees (which would be denied the exclusion under the proposal) that the classic determinable fee—"to *A* and his heirs for as long as the land is used for agricultural purposes"—is not created for estate planning motives. But if the exclusion were allowed for determinable fees yet denied for term interests under trusts, the effect of the proposal could be vitiated by creating a determinable fee such as "to *A* and his heirs for as long as *A* remains under the age of 30."[321] Thus, the fact that the proposal would deny the exclusion for determinable fees is not a shortcoming.

The proposal would have a serious impact on interest-free loans. By 1984, Congress had become concerned that interest-free loans between family members could be used as a device for circumventing the assignment-of-income doctrine and the grantor trust rules.[322] Accordingly, as part of the Tax Reform Act of 1984, Con-

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321. Although a determinable fee for a term could be created as a substitute for a classic term of years, the two interests are not identical. Compare a conveyance "to *A* (who is twenty-one years old) for ten years, remainder to *B* and his heirs" with a conveyance "to *A* and his heirs for as long as *A* remains under the age of thirty-one, then to *B* and his heirs." Under the first conveyance, *B* as a vested remainder; under the second, an executory interest. It is likely that *A*'s rights to use the land during the period of his possession are greater under the second conveyance than under the first, and that *B*'s rights to enjoin acts of waste by *A* are correspondingly less under the second than under the first. *See* L. SIMES & A. SMITH, FUTURE INTERESTS §§ 1651-64 (2d ed. 1956) (§ 1664 in particular).

322. *See* H.R. REP. No. 432, Part II, 98th Cong., 2d Sess. 1373-74, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1020-21.

A high-bracket parent with a low-bracket child would naturally like his income to be taxed at the child's lower rates. But to achieve such a result, the taxpayer would ordinarily have to relinquish control over the property producing such income. (Indeed, as a result of changes made by the Tax Reform Act of 1986, Pub. L. 99-514 (1986), even an absolute reliquishment of control might not produce that desired tax result. *See* § 1(i), added by the Tax Reform Act of 1986.) If a parent owns an income-producing asset but attempts to assign the income from that asset to his child for a fixed term, the parent will continue to pay the income tax, pursuant to the assignment-of-income doctrine, on the assigned income. Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930) (the famous "fruit" and "tree" metaphor). If, instead, the parent transfers the property in trust, with the income to be paid to the child for a fixed term, followed by a reversion to the grantor-parent, the parent will continue to pay income tax on the trust income unless the present value of the reversion at the trust's inception is small. *See* § 673. as amended by the Tax Reform Act of 1986.

gress added section 7872 to the Internal Revenue Code.[323] This section provides in part that if an individual makes a loan on an interest-free basis or at an interest rate below market,[324] where such forgoing of interest is in the nature of a gift, the forgoing of interest must be regarded for gift tax purposes as a gratuitous transfer of that forgone interest from the lender to the borrower. The lender is deemed to have made a gift to the borrower of the right to use that lent money, and the value of such right is calculated by using market interest rates.[325]

Will this imputed gift qualify for the annual exclusion? Under current law, the answer is probably yes. Even before the 1984 enactment of section 7872, the United States Supreme Court held in *Dickman v. Commissioner*[326] that as a matter of pre-1984 law an interest-free demand loan (at least in the case of an intrafamily transaction) constituted a gift for gift tax purposes of the value of the use of the money lent. In its opinion, the Court seemed clearly to have assumed, although without discussion or analysis of the question, that such a gift would qualify for the annual exclusion by virtue of its being a present interest.[327] The Court regarded as the gift the use of the lent money for the period the lender permitted the loan to remain outstanding, just as the right to live in a house rent-free at the owner's sufferance would be a gift of the use of the house. Thus, said the Court, the *value* of the gift element in an interest-free

But an interest-free demand loan from parent to child, prior to the enactment of § 7872 in 1984, could successfully shift income from parent to child. Suppose the parent lent $50,000 to his child, the loan being repayable whenever the lender might demand payment (a so-called "demand" loan). Thus, the parent never lost control over the $50,000 principal. After the child received the loan, he invested the money at twelve percent interest, and he (rather than his high-bracket parent) paid the income tax on the interest income. If the parent was in the fifty percent bracket and the child was in the fifteen percent bracket, the family would retain only $3,000 of the $6,000 of interest earned if the parent were taxable on the interest; but since the child was the person taxable on the income, the family retained $5,100 of the $6,000 interest earned.

323. Tax Reform Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494, 699 (1984).

324. The rules for determining whether a loan is indeed "below market" vary, depending on whether the loan is a term loan or a demand loan. § 7872(e); Prop. Treas. Reg. § 1.7872-3 (1985), 50 Fed. Reg. 33,558 (1985).

325. The operation of this feature of § 7872 may be illustrated as follows. Suppose a lender lends $50,000 interest-free to a borrower, the loan to be repayable on demand of the lender. Assume that the "blended annual rate" for the calendar year is 11.0%. (The term "blended annual rate" is, in essence, an average of certain federal short term interest rates established by the IRS pursuant to § 1274(d). The term is defined in Prop. Treas. Reg. § 1.7872-13(a) (1985), 50 Fed. Reg. 33,568 (1985), although it does not appear in the statute.) If the lender permits the loan to remain outstanding throughout the entire calendar year, he will be deemed to have made a gift to the borrower for gift tax purposes of $5,500 on December 31 of that year. § 7872(a)(2).

326. Dickman v. Commissioner, 465 U.S. 330 (1984).

327. *Id.* at 340-41. On this point, the dissenters agreed with the majority. *Id.* at 351.

demand loan is the amount of the interest that the borrower could earn by investing the lent funds at the market rate during the period that the lender permitted the loan to remain outstanding, just as the value of the gift element under a rent-free lease would be the amount of rent that the tenant would have had to pay at the market rate for the term of the lease. The new section 7872 takes the same view as *Dickman* as to what constitutes the gift element in an interest-free demand loan.[328] Thus, if a lender makes a $50,000 demand loan at a time when the prevailing market interest rate is eleven percent, both *Dickman* and section 7872 would treat the lender as if he had made a gift to the borrower (for as long as the loan was permitted to remain outstanding) of the income (assuming an eleven percent yield) that $50,000 would produce. In view of the prevailing understanding that an unconditional income interest that begins immediately is a present interest, the imputed gift arising from such a loan under *Dickman* or section 7872 must be regarded as a present interest.[329]

Although, under current law, a gift arising from an interest-free loan pursuant to section 7827 will qualify for the annual exclusion, such a gift would not qualify under the proposal.[330] Again, if a

328. The statute deems the lender to have made a gift of the forgone interest to the borrower. The Conference Report, however, explains the theory underlying this result: that "the lender [has] made a gift . . . to the borrower which, in turn, is used by the borrower to pay the interest." H. CONF. REP. No. 98-861, 98th Cong., 2d Sess. 1015, *reprinted in* 1984 U.S. CONG. & AD. NEWS 1445, 1703.

329. Might it not logically be urged that no gift at all arises from an interest-free loan, since the transferor (the lender) can revoke the gift at any time by recalling the loan and demanding repayment? *See* Burnet v. Guggenheim, 288 U.S. 280 (1933) (holding that transfers revocable by the donor at any time are not gifts for gift tax purposes, because the donor has not relinquished dominion and control over the property so long as he retains the revocation power). The answer is a negative one. The theory of *Dickman* and § 7872 is that the lender's gift consists not in his transfer of funds to the borrower at the time the loan is established, but rather in his allowing the loan to remain outstanding (and thus allowing the borrower to enjoy the use of the money). Indeed, an interest-free loan may be unique among gifts in that it becomes a gift only as time passes and it is permitted to remain unrepaid. The fact that the gift is deemed by § 7872 to occur in a lump sum on December 31 of each calendar year during which the loan is permitted to remain outstanding is merely a device—a fiction, if you will—that enables the IRS to assign a value in some consistent manner to this gift that has been consummated over a period of time. (The IRS has occasionally ruled that if a gift cannot be valued at the time it is actually made, the transfer will be *deemed* to have been made at such later time as the gift first becomes susceptible of valuation. Rev. Rul. 81-31, 1981-1 C.B. 475; Rev. Rul. 73-61, 1973-1 C.B. 408; Rev. Rul. 69-347, 1969-1 C.B. 227; Rev. Rul. 69-346, 1969-1 C.B. 227. All but the most recent of these rulings were cited in *Dickman.*)

330. If it were proper to analogize a gift in the form of an interest-free demand loan to a gift under a revocable trust (the discussion *supra* at note 329 indicates that it would not be proper), the gift of the forgone interest *would* qualify for the exclusion even under the proposal. Although, when a settlor establishes a revocable trust, no gift occurs at the time of settlement, *see supra* note 329, a gift *does* occur at such later time as the trustee

lender makes an interest-free loan of $50,000 at a time when the "blended annual rate"[331] for the calendar year is 11.0% and permits the loan to remain outstanding for the entire calendar year, he will be deemed to have made a gift to the borrower of $5,500 on December 31 of that year. And this gift, as the analysis of *Dickman* and section 7872 has shown, is in substance if not in form a gift to the borrower of the income that $50,000 would produce if invested at the blended annual rate. Such a gift is clearly not a gift of the entire legal and equitable interest in property and would therefore not qualify for the exclusion under the proposal. This result should not be regarded as a shortcoming of the proposal, for section 7872(c)(2) provides a *de minimis* exception: loans between individuals will not be regarded as gifts for gift tax purposes if the aggregate outstanding amount of the loans between such individuals does not exceed $10,000.[332] Thus, routine interest-free loans made as accommodations—for example, an interest-free loan to a child to enable him to make a down-payment on an automobile—would, even under the proposal, be excluded from the tax base, while interest-free loans made for tax-planning motives[333] would be taxed.

Another asset that might present difficulties under the proposal would be an annuity or life insurance contract. If the contract is given to a donee on such terms as to enable the donee—immediately after the gift—to realize the wealth represented by the contract (that is, to cash in the policy for its cash surrender value), then the gift should be regarded as a present interest; otherwise, not.[334]

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makes a distribution of income to the income beneficiary. The gift consists of that distributed portion of income, for the settlor has, at the time of the income distribution, relinquished (by permitting the trustee to distribute it rather than revoking the trust) control over that portion of income. Thus, if the trust earned $5,500 of income and the trustee distributed that amount to the income beneficiary, the settlor would be deemed to have made a gift of $5,500 at the time of the distribution. Even under the proposal, such a gift of $5,500 would be the gift of a present interest because the donee would thereupon have received full legal and equitable title to the gift property. In other words, if an interest-free loan under § 7872 were analogized to a gift of income paid under a revocable trust, the gift would qualify for the exlusion under the proposal.

331. *See supra* note 325.

332. This *de minimis* exception does not apply to loans to the extent the proceeds are used to purchase or carry income-producing assets. § 7872(c)(2)(B). The obvious reason for denying the exemption to such loans is that they are plainly calculated to circumvent the assignment-of-income and grantor trust rules. *See supra* note 322. Section 7872(c)(2)(B) is designed to prevent abuse.

333. *See supra* note 332.

334. Much could be said for denying the exclusion, under the proposal, to gifts of such contracts. A gift of a life insurance policy is ordinarily made *only* for tax planning motives. Prior to the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, § 2035 provided that a gift made by a decedent within three years of his death would be included in his gross estate if the gift was made by him "in contemplation of death:" that

The proposal also raises questions in connection with the marital deduction. If a husband bequeaths property in trust, where the income is to be paid to his wife for life and the remainder is to be paid to another, that bequest, because it is a terminable interest, will not ordinarily qualify for the estate tax marital deduction.[335] If certain conditions are met, however, and if the husband's executor so elects, the bequeathed property will be regarded as "qualified terminable interest property" (QTIP), and the entire value of the transferred property (not merely the wife's income interest) will qualify for the deduction.[336] But if the property is a QTIP and the wife, during her life, makes a gift of her income interest,[337] she will be treated as having made a transfer for gift tax purposes of the entire underlying corpus, not merely of the income interest. Suppose a husband bequeaths property in trust, the income to be paid to his wife for life and the remainder to be distributed to *A* upon the wife's death. If, at a time when the corpus is worth $10,000 and the wife's life estate is worth $6,000, the wife makes a gift of her life estate to *B*, the wife will of course have made a gift of $6,000 to *B* pursuant to the normal section 2511 rules; but in addition, under the QTIP

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is, if he had a testamentary state of mind at the time of the gift and regarded the gift as a substitute for testamentary disposition. United States v. Wells, 283 U.S. 102, 116-17 (1931). *See generally* C. LOWNDES, *supra* note 19, at ch. 5. On the other hand, if the gift was made from a "life motive," then the gift was not includable pursuant to § 2035 even if made within three years of the transferor's death. The view was often expressed in those pre-1976 days that because of the peculiarly testamentary nature of life insurance, life motives were more difficult to establish in the case of a gift of life insurance than in the case of a gift of other property. That is, the gift of life insurance was, more likely than not, to be regarded as a gift in contemplation of death and hence subject to estate tax. *See* Rea, *Life Insurance Gifts Subject to Rules in Contemplation of Death,* 6 J. TAX. 30 (1957).

But to amend the proposal so that all gifts of life insurance would be denied the exclusion, irrespective of the donee's rights immediately after the gift to realize the wealth represented by the policy, would, in spite of the theoretical foundation for such an exception, complicate the proposal unduly. And the foundation itself might be a bit shaky. The rationale for regarding life insurance gifts as testamentary transfers is that the transferee realizes little or no value until the transferor's death. *See* Vanderlip v. Commissioner, 155 F.2d 152 (2d Cir.), *cert. denied,* 329 U.S. 728 (1946); First Trust & Deposit Co. v. Shaughnessy, 134 F.2d 940 (2d Cir.), *cert. denied,* 320 U.S. 744 (1943). This rationale weakens when the transferee is able to realize value immediately after the transfer: an ability that should, under the proposal, render such a transfer the gift of a present interest.

335. § 2056(b)(1); *see generally* R. STEPHENS, *supra* note 24 at ¶ 5.06[7].

336. § 2056(b)(7); *see generally* R. STEPHENS, *supra* note 24, at ¶ 5.06[8][d].

337. [T]he beneficiary of a trust, if he is not under a legal incapacity, can transfer his interest under the trust, unless his interest is made inalienable by the terms of the trust or by statute, or unless his interest is of such a character that it cannot be transferred, as, for example, where the trust is for his personal support. . . .

2 A. SCOTT, *supra* note 75, at § 132.

rules, she will be deemed pursuant to section 2519 to have transferred to *A* the $4,000 remainder. Under current law, the $6,000 gift to *B* will qualify as a present interest for the annual exclusion,[338] but the deemed gift of the remainder will not. Under the proposal, neither the gift of the income interest nor the gift of the remainder would qualify.[339]

338. *B*'s interest will be in the nature of an estate *pur autre vie;* his right to income will be measured by the wife's life, not by his own.

339. One commentator has suggested that if the wife had given her income interest to *A*, and if, under local law, the wife's transfer occasioned a merger of *A*'s remainder with his newly-acquired income interest so that *A* thereupon had absolute ownership of the entire $10,000 deemed transferred by the wife, then the full $10,000 would presumably be a present interest and would qualify for the annual exclusion. *See* R. STEPHENS, *supra* note 24, at ¶ 10.08[1]; *see also* Clark v. Commissioner, 65 T.C. 126 (1975), *acq.*, 1977-2 C.B. 1; Rev. Rul. 78-168, 1978-1 C.B. 298. But what would be the result under the proposal? The previous comments about merger might suggest that the entire transfer of $10,000 to *A* ($6,000 actually transferred by the wife and $4,000 deemed to have been transferred by her) would qualify for the annual exclusion, since the application of the merger doctrine results in *A*'s receiving absolute ownership. The flaw in such analysis is that the doctrine of merger, while applicable in the case of legal future interests, does not, strictly speaking, apply in the case of trusts. If the remainderman under a trust acquires the life income interest, the trust does not automatically terminate. Rather, the remainderman gains the power, if he wishes, to compel termination of the trust, but he may not exercise that power unless the settlor's only purpose in creating successive estates under the trust was to enable the beneficiaries successively to enjoy the trust property. *E.g.* Inches v. Hill, 106 Mass. 575 (1871); Bennet v. Tower Grove Bank & Trust Co., 434 S.W.2d 560 (Mo. 1968); In re Stafford's Estate, 258 Pa. 595, 102 A. 222 (1917); Rowley v. American Trust Co., 144 Va. 375, 132 S.E. 347 (1926). In a sense, this power is merely an extension of the normal rule that if all the beneficiaries of a trust consent and are *sui juris* (and after the wife's conveyance, *A* becomes the only beneficiary of the trust), they may compel the termination of the trust unless continuation of the trust is necessary to carry out a material purpose of the trust. RESTATEMENT (SECOND) OF TRUSTS § 337 (1959). But *A* does not have an automatic right to terminate the trust; he must seek court approval and show that a material purpose of the settlor would not be violated by the early termination. If, for example, the court concludes that the settlor postponed *A*'s possession of the trust property until the wife's death in part because he wanted *A* to be somewhat older before he gained such possession, then the court would not permit *A* to compel termination of the trust upon the wife's conveyance to him of her income interest.

This analysis suggests that under the proposal, the wife's conveyance of her income interest to *A* would not render the entire trust corpus eligible for the exclusion. Under the proposal, a power to demand property (such as *A*'s power to seek judicial termination of the trust after the wife's conveyance of the life estate to him), as distinguished from the actual absolute ownership interest itself, would not be a present interest. *See supra* text accompanying notes 315-16. The reader might be tempted to infer that since *A* could not terminate the trust without the consent of the court, even under current law the gift of the income interest to *A* (though a present interest gift as to the income interest itself) would not be a gift of a present interest as to the whole corpus, on the theory that *A* could not gain possession of the whole corpus without the consent of another. *See supra* text accompanying note 149. But such an inference would be unsound. If in fact the early termination of the trust would not thwart a material purpose of the settlor, then the court must grant *A*'s petition to terminate the trust. That is, if in fact early termination would not thwart a material purpose, then the instant

Even under the proposal, it would be desirable to retain a special rule for gifts to minors. If a grandfather wants to make a $1,000 gift to his newly-born granddaughter, it is unlikely that he would regard thrusting the money into the infant's hand as the best way of benefitting her. In the case of minor donees, even "casual, routine" gifts are often made to guardians or custodians, not as a way of making a testamentary kind of transfer, but as a way of assuring that the minor does in fact benefit from the gift. Under current law, an outright gift delivered to the guardian of the intended donee can qualify for the annual exclusion regardless of the guardian's power under local law to control the donee's enjoyment of the property.[340] This rule should certainly be continued under the proposal. But under current law, gifts *in trust* for the benefit of minors may or may not qualify for the exclusion, depending upon the authority of the trustee and the interest of the beneficiary. Under the proposal as originally stated, such gifts would never qualify. It is recommended, however, that the special exception of section 2503(c) be retained so that donors could continue to make qualifying gifts to minors by means of custodians[341] and by means of analogous trusts established simply to assure prudent management until the donee becomes an adult.

The proposal for changing the definition of "future interest" certainly would simplify the law considerably. It would render moot, for example, such confusing lines of cases as (1) those in which the availability of the exclusion may turn upon whether the assets in the trusts are income-producing;[342] (2) those in which the trustee's discretionary powers may be too broad to assure the beneficiary a "steady flow" of income;[343] and (3) those where a beneficiary has been given a power to demand a distribution but it is not clear whether that power may as a practical matter be exercised.[344] The proposal would also adhere more closely than present law to the intent of Congress, since it would more truly limit the annual exclusion to routine gifts not intended to yield tax-planning benefits. It must be admitted, however, that the proposal would substantially reduce the availability of the exclusion.

the wife transfers the life estate to *A*, *A* has the unrestricted power to terminate the trust; he must go to court only to establish that in fact he had that right the instant after the conveyance of the life estate.

340. *See* United States v. Baker, 236 F.2d 317, 320 (4th Cir. 1956); Rev. Rul. 59-78, 1959-1 C.B. 690.

341. *See supra* note 281.

342. *See supra* text accompanying notes 70-89.

343. *See supra* text accompanying notes 158-98.

344. *See supra* text accompanying notes 272-309.

But such reduction would not work to the detriment of the transfer tax system; quite the contrary. Prior to 1976, gift tax rates were only three-quarters of the parallel estate tax rates. For example, taxable transfers totalling $400,000 were taxed, if made at death and subjected to the estate tax, at a marginal rate of 32%, whereas they were taxed, if made inter vivos and subjected to the gift tax, at a marginal rate of only 24%. The purpose of this discrepancy was undeniably to encourage lifetime giving, particularly among the elderly.[345] But by 1976, Congress had become convinced that this dual system of transfer taxation unduly favored the wealthy.

> As a practical matter, the [tax] preferences for lifetime transfers are available only for wealthier individuals who are able to afford lifetime transfers. The preferences for lifetime transfers are not generally available for those of small and moderate wealth since they generally want to retain their property until death to assure financial security during lifetime. Therefore, your committee believes that the preferences for lifetime transfers principally benefit the wealthy and result in eroding the transfer tax base.
>
> Your committee believes that it is desirable to reduce the disparity of treatment between lifetime and deathtime transfers through the adoption of a single unified estate and gift tax rate schedule providing progressive rates based on cumulative lifetime and deathtime transfers.[346]

In other words, the two-tiered rate structure impaired the progressivity of the transfer tax system, since wealthier individuals were better able to avail themselves of the lower rates applicable to inter vivos gifts. Consequently, gift tax rates were made comparable to estate tax rates by the Tax Reform Act of 1976.[347]

Because the annual exclusion is available for transfers under the gift tax but not for transfers under the estate tax, the exclusion, too, impairs the progressivity of the transfer tax system insofar as the wealthy are better able to make substantial inter vivos gifts than the nonwealthy. Hence, the exclusion is justifiable only to the extent it lubricates the day-to-day process of casual gift-giving it is not justifiable to the extent it permits individuals to avoid estate tax.[348] The

345. *See* A. CASNER & R. STEIN, ESTATE PLANNING UNDER THE TAX REFORM ACT OF 1976 75 (2d ed. 1978).

346. H.R. REP. No. 94-1380, 94th Cong., 2d Sess. 11-12 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3365-6.

347. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-8.

348. *See* H. R. No. 2333, 77th Cong., 1st Sess. (1942), *reprinted in* 1942-2 C.B. 372, 403, explaining why Congress chose to reduce the dollar amount of the annual exclusion from $4,000 to $3,000 in the Revenue Act of 1942, Pub. L. 77-753, § 454, 56 Stat. 798, 953 (1942).

proposal, as it further restricted availability of the annual exclusion, would help to preserve the progressivity of the federal transfer tax system.

VI. Conclusion

The current rule denying future interests eligibility for the annual exclusion has been needlessly complicated by the definition of "future interest" that has evolved since the rule's inception. Distinctions between income-producing and non-income-producing property and between minor and adult trust beneficiaries, and special rules regarding trustees' discretionary powers, have crept into the law to no useful purpose. While the total repeal of the annual exclusion would be an unwise simplification measure, since as a result of such repeal every small, routine gift would become a reportable transaction, needed simplification can be achieved, consistently with Congress's original purpose in enacting the exclusion, by amending section 2503 to provide that a gift will qualify for the exclusion only if the donee receives at the moment of the gift the entire legal and equitable title to the gift property.